

REGULATORY AND TAX TREATMENT OF ELECTRIC INTERCONNECTION FACILITIES

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I. INTRODUCTION

Over the last twenty-five years, the electric power industry has been transformed from one that favored vertically-integrated monopolies to one that now generally endorses competitive generation supply. The evolution of the industry has created new suppliers of power and new forms of grid ownership and governance. One of the issues generators have had to confront through this evolution is that of interconnecting a new plant to the grid. Without an interconnection, few generators would be able to serve load.

The Federal Energy Regulatory Commission (FERC) is currently considering the standardization of interconnection agreements and policies through a rulemaking proceeding.¹ Among other things, the FERC recognizes that a generator's payment for a grid owner's interconnection facilities has federal income tax implications.² The FERC's approach has been to allow parties to an interconnection agreement to include tax gross-ups or indemnity provisions.³ While the FERC's order in the Interconnection Rulemaking may provide clarity with regard to which party bears the risk and the economic burden of taxes associated with an interconnection, it will not address the taxation of an interconnection *per se*. Instead, taxpayers, the Internal Revenue Service (IRS or Service), and perhaps Congress must address the federal income tax consequences of an interconnection transaction.

Taxes associated with interconnections will inherently affect the cost of power from, and the cost of entry for, competitive generators. Accordingly, utilities, generators, and consumers should each want the lowest possible tax burden. In addition, the tax liability is often significant and will affect the amount that needs to be recouped in either the generator's or the transmission owner's rates.⁴ The parties to an interconnection agreement generally desire

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1. Notice of Proposed Rulemaking, *Standardization of Generator Interconnection Agreements and Procedures*, F.E.R.C. STATS & REGS. ¶ 32,560 (Apr. 24, 2002), 99 F.E.R.C. ¶ 61,086 (Apr. 24, 2002), 67 Fed. Reg. 22,250 (May 2, 2002) (to be codified at 18 C.F.R. pt. 35 (2002)) [hereinafter *Interconnection Rulemaking*].

2. *Id.* at 34,179, 34,208-34. This paper discusses United States federal income tax consequences only.

3. *Interconnection Rulemaking*, *supra* note 1, at 34,179, 34,208-34.

4. While the cost of interconnection facilities are project specific, the magnitude of costs and

certainty as to the tax consequences for two reasons. First, if the tax liability falls on the utility and there is no gross-up or indemnity provision, the regulated utility would want to reflect this expense as soon as possible in its next-filed rate case. On the other hand, if the tax liability ultimately falls on the generator, the generator would want to know its full costs associated with constructing its plant (including taxes) before entering into long-term sales agreements for its output. To accommodate the need for certainty, the IRS has issued several IRS notices that provide details of safe harbor electric interconnection transactions that are not taxable, the most recent of which is IRS Notice 2001-82.⁵

A review of the historical regulatory and tax treatment of interconnection facilities since the beginning of the twentieth century may help to frame the analysis of the appropriate tax treatment of interconnections for the modern electric industry. Although safe harbors provide certainty, the IRS has not issued guidance on all issues. Extending the safe harbors to all stand-alone generators, as the Service did in IRS Notice 2001-82, was a welcome and necessary step. But issues that continue to be unanswered by the safe harbors, such as the tax treatment of transmission credits to generators paying for system upgrades, the tax implications for transmission providers not treated as corporations for tax purposes, and the tax treatment of transactions falling outside the safe harbors, must be analyzed under general tax principles.

II. OVERVIEW OF RATEMAKING TREATMENT OF INTERCONNECTION COSTS

A. *Interconnection Cost Recovery Prior to Competition*

The electric power industry in the United States can trace its roots to the late nineteenth century. From its inception until the 1920s, electric utility regulation existed only at state and local levels.⁶ For the most part, utilities were very limited geographically and did not have interstate operations. Given the intensive capital investment required, the general belief was that a "natural monopoly" approach to electric service was more efficient economically than a competitive approach.⁷ With this view, and the desire to encourage investor-owned utilities to expand their systems to serve more customers, state and local authorities awarded monopolies to electric utilities in specific service territories.⁸ In return, investor-owned utilities were typically required to submit to state government regulation, which generally established standards for electric service, regulated rates, and established and monitored permitted returns on equity investment.⁹

potential tax liability are usually in the millions of dollars.

5. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619.

6. Lynn R. Coleman & Matthew W.S. Estes, *State Utility Commission Regulation of Energy Transactions*, in ENERGY LAW AND TRANSACTIONS § 4.02[1][a] at 4-7 (2002).

7. ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 11-19 (John Wiley & Sons, Inc., 1970).

8. THOMAS R. CASTEN, TURNING OFF THE HEAT 38-42 (Prometheus Books 1998).

9. Stanley A. Martin, Comment, *Problems with PURPA: The Need for State Legislation to Encourage Cogeneration and Small Power Production*, 11 B.C. ENVTL. AFF. L. REV. 149, 153 (1983).

With the passage of the Federal Water Power Act (FWPA) in 1920, the federal government began its foray into the energy regulatory arena.¹⁰ The FWPA established the Federal Power Commission (FPC) and provided federal jurisdiction over hydroelectric projects.¹¹ However, the FWPA did not provide for the rate regulation of electric utilities.¹² Rate regulation over wholesale sales and the transmission of electricity in interstate commerce commenced with the passage in 1935 of the Federal Power Act (FPA).¹³

Vertically-integrated electric utilities dominated the electric industry, and these utilities owned generation, transmission, and distribution facilities within their own service territories.¹⁴ Indeed, electric utilities generally built their own power plants and transmission systems, entered into interconnection and coordination arrangements with neighboring utilities, and entered into long-term sales agreements with municipal, cooperative, and other investor-owned utilities.¹⁵ While the FPA, as enacted in 1935, contains provisions regarding interconnection, these provisions were primarily to facilitate interconnection of utility systems across the country and did not facilitate or encourage competitive generation.¹⁶

10. Federal Water Power Act, ch. 285, 41 Stat. 1063 (1920) (codified at 16 U.S.C. §§ 791a - 824m (2002)).

11. The FWPA became Part I of the Federal Power Act.

12. Public Util. Comm'n of R.I. v. Attleboro Steam & Elec. Co., 273 U.S. 83 (1927).

13. The FPA amended the FWPA and, for the first time, established rate regulation over electric utilities' rates in interstate commerce.

14. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (codified at C.F.R. pts. 35, 385) [hereinafter Order No. 888]; Order No. 888-A, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), 62 Fed. Reg. 12,274 (1997) (codified at C.F.R. pt. 35) [hereinafter Order No. 888-A]; Order No. 888-B, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 81 F.E.R.C. ¶ 61,248 (1997), 62 Fed. Reg. 64,688 (1997) (codified at C.F.R. pt. 35); Order No. 888-C *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 82 F.E.R.C. ¶ 61,046 (1998); *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000); *New York v. FERC*, 122 S.Ct. 1012 (Mar. 4, 2002).

15. Order No. 888, *supra* note 14, at 31,639.

16. Section 202 of the FPA is entitled "Interconnection and Coordination of Facilities; Emergencies; Transmission to Foreign Countries." F.P.A. § 202 (1935) (codified at 16 U.S.C. § 824(b) (2002)). Section 202(b) facilitates the interconnection of utility systems, and provides in pertinent part as follows:

Whenever the Commission, upon application of any State commission or of any person engaged in the transmission or sale of electric energy, and after notice to each State commission and public utility affected and after opportunity for hearing, finds such action necessary or appropriate in the public interest it may by order direct a public utility (if the Commission finds that no undue burden will be placed upon such public utility thereby) to establish physical connection of its transmission facilities with the facilities of one or more persons engaged in the transmission or sale of electric energy, to sell energy to or exchange energy with such persons: *Provided*, That the Commission shall have no authority to compel the enlargement of generating

Since the early days of regulation, rates for electric service have generally been based on a utility's cost of providing service. This approach allows utilities to recover their prudently incurred expenses, and receive a reasonable return on prudent investment in plant and equipment, or "rate base."¹⁷ In practice, the cost-of-service method allows utilities to include in rate base all facilities needed to interconnect their power plants to the grid. The FPC and the FERC enunciated a "strong preference" for the inclusion of all of a public utility's transmission facilities in its rate base because the transmission grid operates as an "integrated whole," attaining maximum reliability and efficiency "at a minimum cost on a system wide basis. Implicit in this theory is the assumption that all customers, whether they be wholesale, retail or wheeling customers, receive the benefits that are inherent in such an integrated system."¹⁸ Indeed, the FPC and the FERC allowed exceptions to this strong preference only in limited circumstances.¹⁹

Under the view that monopolies should be the exclusive providers of bundled electric service, true competition from independently owned generators was virtually nonexistent before 1978. The only notable exceptions were a few large industrial firms with "inside the fence" generation in energy-intensive industries, such as the pulp and paper industry. While these industrials generally consumed the entire output of their generation facilities, they still required electric service from the local utility when their on-site generation experienced an outage or could not satisfy their full load. Thus, they needed to establish and maintain interconnections. There was little law these industrials could rely upon to require a utility to offer reasonable terms for interconnection or back-up service. Interconnection issues were addressed in separate agreements, or in utilities' retail tariffs.

facilities for such purposes, nor to compel such public utility to sell or exchange energy when to do so would impair its ability to render adequate service to its customers. *Id.*

Given that state law and municipal franchises limit which entities could own generation and sell electricity, Section 202(b) effectively applied only to utility systems. Indeed, up until the mid-1960s, there was a question as to whether municipal systems could even rely on Section 202(b) to compel interconnection. *New England Power Co. v. FPC*, 349 F.2d 258 (1st Cir. 1965). Moreover, until 1978, the Commission was not given the authority to order a public utility to provide transmission service. *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973).

17. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 276 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Violet v. FERC*, 800 F.2d 280 (1st Cir. 1986) (citing *Mississippi ex rel. S.W. Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 289 n.1 (1923) (Brandeis, J., concurring)).

18. Opinion No. 93, *Otter Tail Power Co.*, 12 F.E.R.C. ¶ 61,169, 61,420 (1980).

19. The FERC permitted departures from its general rule and hence permitted utilities to directly assign the cost of specific facilities to customers, under the following conditions: (i) the facility is physically separate from the utility's service territory; (ii) the facility is separate electrically from the utility's transmission system; (iii) the utility did not construct the facility to serve densely populated areas of its territory; and (iv) the utility and the customer agree to such treatment by contract. Opinion No. 82, *Idaho Power Co.*, 3 F.E.R.C. ¶ 61,108 (1978).

B. *Interconnection Cost Recovery After Competition Emerges*

1. Legislative and Regulatory Changes that Spurred Competitive Generation

Beginning with passage of the Public Utility Regulatory Policies Act of 1978 (PURPA),²⁰ the electric industry witnessed the gradual evolution away from the FERC's traditional ratemaking concepts and the meaningful emergence of competitive generation that needed to interconnect to the grid and secure transmission.

Congress enacted PURPA in the wake of the energy crisis of the 1970s. Through PURPA, Congress sought to decrease dependence on imported oil by encouraging efficient electricity generation and use of renewable resources to produce electricity. PURPA establishes special categories of favored generators called qualifying facilities (QF) and bestows several important benefits on QFs. These benefits include the exemption from state and federal utility-type regulation, the right to interconnect to the grid, and the right to receive standby services (*i.e.*, back-up, maintenance, and supplemental services) under reasonable and non-discriminatory terms. In addition, PURPA requires that utilities offer to purchase QFs' electric output,²¹ which helps ensure a market for QFs' electric sales. PURPA also amended the FPA by adding Sections 210 and 211, which expanded significantly the FERC's²² interconnection authority²³ and, for the first time, provided the FERC with authority to order transmission.

There are two types of QFs under PURPA—cogeneration facilities and small power production facilities. Cogeneration facilities produce electricity and

20. Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (codified in scattered sections of 16 U.S.C.).

21. The FERC then determined that utilities were required to offer to pay for such QF power at a rate equal to the purchasing utility's "avoided cost." 16 U.S.C. § 824a-3(b), (d) (2002); 18 C.F.R. § 292.304 (2002). The QF's costs of service were not considered for determining avoided cost rates—rather the FERC considered only the purchasing utilities' costs.

22. In 1977, the Department of Energy Organization Act created the FERC, which assumed most of the functions of the FPC. 42 U.S.C. § 7172 (2002).

23. PURPA amended the FPA § 210(a) to read as follows:

Upon application of any electric utility, Federal power marketing agency, geothermal power producer (including a producer which is not an electric utility), qualifying cogenerator, or qualifying small power producer, the Commission may issue an order requiring—

(A) the physical connection of any cogeneration facility, any small power production facility, or the transmission facilities of any electric utility, with the facilities of such applicant,

(B) such action as may be necessary to make effective any physical connection described in subparagraph (A), which physical connection is ineffective for any reason, such as inadequate size, poor maintenance, or physical unreliability,

(C) such sale or exchange of electric energy or other coordination, as may be necessary to carry out the purposes of any order under subparagraphs (A) or (B), or

(D) such increase in transmission capacity as may be necessary to carry out the purposes of any order under subparagraph (A) or (B). 16 U.S.C. § 824i (2002).

Note, that as used in the FPA, "'electric utility' means any person or State agency . . . which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency." 16 U.S.C. § 796(22) (2002). With this in mind, the reach of the FPA § 210 is exceptionally broad.

forms of useful thermal energy for industrial, commercial, and heating or cooling purposes through the sequential use of energy.²⁴ Small power production facilities generate electricity from waste, biomass, renewable resources, geothermal resources, or any combination thereof.²⁵ PURPA and the FERC's implementing regulations establish the standards that define both types of QFs.²⁶ One of the standards that applies to each type of QF relates to ownership. Specifically, entities that are primarily engaged in the generation or sale of electricity (*i.e.*, most electric utilities) cannot own more than 50% of the equity interest in a QF.²⁷ Thus, PURPA represents the first legislatively mandated crack in the vertically-integrated monopoly structure because it encouraged the development of privately-owned generation facilities that could compete with utility-owned generation.²⁸

Entities referred to as independent power producers (IPP) began to appear on the scene after PURPA was enacted.²⁹ IPPs are generally single-asset companies that own generation facilities that cannot meet PURPA's QF requirements.³⁰ While wholesale electric sales by QFs are generally exempt

24. 16 U.S.C. § 796(18) (2002); 18 C.F.R. §§ 292.202(c), 292.205 (2002).

25. 16 U.S.C. § 796(17)-(22) (2002); 18 C.F.R. § 292.204 (2002).

26. 16 U.S.C. § 796(17)-(22) (2002); 18 C.F.R. §§ 292.203-292.206 (2002).

27. The FERC's regulations provide in pertinent part as follows:

(a) *General Rule.* A cogeneration facility or small power production facility may not be owned by a person primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities).

(b) *Ownership Test.* For purposes of this section, a cogeneration or small power production facility shall be considered to be owned by a person primarily engaged in the generation or sale of electric power, if more than 50 percent of the equity interest in the facility is held by an electric utility or utilities, or by an electric utility holding company, or companies, or any combination thereof. If a wholly or partially owned subsidiary of an electric utility or electric utility holding company has an ownership interest in a facility, the subsidiary's ownership interest shall be considered as ownership by an electric utility or electric utility holding company.

(c) *Exceptions.* For purposes of this section a company shall not be considered to be an "electric utility" company if it:

(1) Is a subsidiary of an electric utility holding company which is exempt by rule or order adopted or issued pursuant to section 3(a)(3) or 3(a)(5) of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79c(a)(3), 79c(a)(5); or

(2) Is declared not to be an electric utility company by rule or order of the Securities and Exchange Commission pursuant to section 2(a)(3)(A) of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79b(a)(3)(A).

18 C.F.R. § 292.206 (2002).

28. Municipal utilities and cooperatives existed prior to PURPA. While some municipal utilities and cooperatives owned generation, it was fairly common for these entities to purchase electricity from investor-owned utilities. *See generally* Otter Tail Power Co. v. United States, 410 U.S. 366 (1973).

29. Power marketers and brokers also appeared on the scene. Power marketers do not own generating assets but purchase and resell electricity at wholesale. Power brokers neither generate electricity nor take title to and sell electricity. Instead, power brokers are middlemen that are compensated for introducing a buyer and seller, and facilitating a sale. The FERC exercises jurisdiction over power marketers wholesale sales of electricity in interstate commerce, but has declined to exercise jurisdiction over power brokers. *See generally* Citizens Energy Corp., 35 F.E.R.C. ¶ 61,198 (1986); Citizens Power & Light Corp., 48 F.E.R.C. ¶ 61,210 (1989); Heartland Energy Serv., Inc., 68 F.E.R.C. ¶ 61,223 (1994).

30. Order No. 888, *supra* note 14, at 31,642-3; *see also* Orange & Rockland Utils., Inc., 42

from the FERC's rate regulation under PURPA, IPPs are "public utilities" under the FPA³¹ and are subject to the FERC's rate jurisdiction under the FPA.

Traditionally, the FERC determined whether or not a jurisdictional entity's rates under a contract were "just and reasonable" by focusing on the seller's cost of service. For IPPs this exercise was not always easy because they sold power under bilateral agreements at negotiated rates. The FERC acknowledged that unlike vertically-integrated utilities, some IPPs could not exert market power. Thus, the FERC began to rethink its approach to rate regulation. Starting in the late 1980s, the FERC permitted certain IPPs without market power to depart from the traditional cost-based approach and to charge market-based rates for their output.³²

Many utilities attempted as well to organize affiliated subsidiaries to own and operate interests in competitive generation facilities.³³ However, the Public Utility Holding Company Act of 1935 (PUHCA) posed a major impediment to their participation in IPPs because ownership of an IPP was equivalent to

F.E.R.C. ¶ 61,012 (1988) (accepting rate schedules for purchase of power by a utility from three IPPs) [hereinafter *Orange & Rockland*].

31. The FPA section 201(e) defines "public utility" as "any person who owns or operates facilities subject to the jurisdiction of the Commission under this Part . . ." *Hartford Elec. Light Co. v. FPC*, 131 F.2d 953 (2d Cir. 1942). Wholesale power sales contracts constitute jurisdictional facilities for purposes of this section. *Id.*

32. In early cases, the FERC referred to such rates as "market-oriented" rates. For such rates to be acceptable, the FERC required IPP sellers to show that they lacked market power over the applicable utility or sufficiently mitigated any market power. *Orange & Rockland*, *supra* note 30; *Ocean State Power*, 44 F.E.R.C. ¶ 61,261 (1988) (accepting avoided cost rates); *Doswell Ltd. P'ship.*, 50 F.E.R.C. ¶ 61,251 (1990) (avoided cost rates); *Dartmouth Power Assocs. Ltd. P'ship.*, 53 F.E.R.C. ¶ 61,117 (1990) (accepting rates based on negotiated pricing formulae). Given the lack or mitigation of market power, the FERC found these "market-oriented" rates to fall within the statutorily mandated zone of reasonableness. *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987). Later, the FERC's inquiry matured to require the lack or mitigation of market power in generation and transmission. *Hearland Energy Serv., Inc.*, 68 F.E.R.C. ¶ 61,223 (1994). For an affiliate of a transmission-owning public utility to receive market-based rates, the FERC required the filing of an open access transmission tariff to demonstrate the lack or mitigation of transmission market power. *Id.*

Market-based rates have evolved, and today market-based rates authorize the seller to charge whatever it and a buyer have agreed upon for such wholesale sales. Today, to obtain market-based rate authorization, an applicant must still demonstrate that it lacks market power by showing that it, together with its affiliates: (1) does not dominate the generation of power in the relevant market; (2) lacks the ability to block buyers from reaching other sellers using transmission facilities that it owns or controls; and (3) cannot erect or control any other barrier to market entry. *See generally Huntington Beach Dev., L.L.C.*, 96 F.E.R.C. ¶ 61,212 (2001), *reh'g denied*, 97 F.E.R.C. ¶ 61,256 (2001), *reh'g denied*, 98 F.E.R.C. ¶ 61,252 (2002).

33. For example, Niagara Mohawk Power Corporation, a franchised investor-owned electric utility in New York State, created an entity known as Hydra-Co Enterprises, Inc., which participated in both QF and IPP projects. *See generally Beebee Island Corp.*, 68 F.E.R.C. ¶ 61,262 (1994). Affiliates of New England Electric Systems, Eastern Utilities Association, and Newport Electric Corporation acquired partnership interests in Ocean State Power, an IPP that owned a combined-cycle generation facility in Rhode Island. *Ocean State Power*, 43 F.E.R.C. ¶ 61,466 (1988). Additionally, for example, the holding company parent of Southern California Edison, a franchised investor-owned electric utility in California, created Mission Energy Company to invest in IPPs and QFs. *See generally Long Lake Energy Corp.*, 51 F.E.R.C. ¶ 61,262 (1990).

ownership of an "electric utility company" under PUHCA.³⁴ To further encourage competitive generation supply and address utilities' PUHCA concerns, Congress passed the Energy Policy Act of 1992 (EPAct). The EPAct amended PUHCA and established, among other things, entities known as exempt wholesale generators (EWG), which could be wholly or partially owned by utilities.³⁵ EWGs are not considered "electric utility companies" under PUHCA and are exempt from PUHCA.³⁶ In addition, the EPAct amended FPA sections 211 and 212 and added FPA sections 213 and 214.³⁷ These revisions expanded the FERC's authority to order utilities to provide certain transmission in interstate commerce and to interconnect certain generators.

Initially, the FERC attempted to implement the EPAct revisions to the FPA on a case-by-case basis to promote transmission access. Dissatisfied with this approach, the FERC considered ways to foster competition and eliminate undue discrimination in the provision of transmission service. These efforts culminated in 1996, with FERC's Order No. 888.³⁸ Among other holdings,³⁹ Order No. 888 required all FERC jurisdictional utilities to file *pro forma* transmission tariffs to govern the provision of transmission service to eligible customers on an open-access, non-discriminatory basis.⁴⁰ Although Order No. 888 indicated that open

34. Public Utility Holding Company Act, ch. 687, § 2(a)(3), 49 Stat. 838 (1935) (codified at 15 U.S.C. § 96(a)(3) (2002)); Order No. 888, *supra* note 14, at 31,642. Regulation under the PUHCA can be particularly burdensome for non-exempt holding companies. Non-exempt holding companies may not acquire "any interest in any business" without prior approval of the Securities and Exchange Commission (SEC); they must register with the SEC and provide detailed financial information about the company; they may not issue debt or equity securities without prior SEC approval; they must be structured in a way that the SEC finds is not unnecessarily complex; they may not make certain intra-company loans or issue certain intra-company dividends; and the ability of non-exempt holding companies to contract with affiliates is limited. 15 U.S.C. §§ 79a-79z-6 (2002).

35. Public Utility Holding Company Act § 32; 15 U.S.C. § 79z-5a (2002).

36. *Id.* EWGs, which are not exempt from the FPA (unless they are also QFs) have often sought and been granted market-based rate authority by the FERC with respect to their wholesale sales if they demonstrate that they do not have market power or take appropriate steps to mitigate the FERC's market power concerns.

37. 16 U.S.C. §§ 824j - 824m (2002).

38. Order No. 888, *supra* note 14, at 31,646, 31,649.

39. Order No. 888 also required "functional unbundling" of wholesale services, the separate provision and pricing of wholesale transmission and wholesale power. Order No. 888, *supra* note 14, at 31,653, 31,698. In order to accommodate functional unbundling, the FERC reversed its long-standing rule requiring utilities to include within transmission rates the cost of generator step-up transformers. To separate the cost of providing wholesale transmission from the cost of wholesale electricity, the FERC held that the cost of generator step-up transformers should be assigned to their related generation facility. *Kentucky Utils. Co.*, 85 F.E.R.C. ¶ 61,274, 62,112-3 (1998).

40. Order No. 888, *supra* note 14, at 31,687-90. The *pro forma* open access transmission tariff generally defined an "Eligible Customer" as follows:

(i) [a]ny electric utility (including the Transmission Provider and any power marketer), Federal power marketing agency, or any person generating electric energy for sale for resale is an Eligible Customer under the Tariff . . . [and] (ii) [a]ny retail customer taking unbundled transmission service pursuant to a state requirement that the Transmission Provider offer the transmission service, or pursuant to a voluntary offer of such service by the Transmission Provider, is an Eligible Customer under the Tariff.

Order No. 888-A, *supra* note 14, at App. B § 1.11.

access transmission required utilities to interconnect transmission customers, the *pro forma* tariff contained no specific provisions to effect such arrangements.

As a result of PURPA, the EPAct, market-based rates, and open access transmission, suppliers of generation now include, in addition to traditional electric utilities, QFs, EWGs, and other IPPs. Indeed, the relative growth in the amount of electricity supplied by non-traditional utilities illustrates the great success of these legislative and regulatory efforts. In 1978, utilities generated approximately 2,206 billion kilowatt hours of electricity, while non-utility power producers generated approximately three billion kilowatt hours of electricity (.14% of the total). In 1999, utilities generated approximately 3,174 billion kilowatt hours of electricity, while non-utility power producers generated approximately 532 billion kilowatt hours of electricity (14.36% of the total).⁴¹ These new suppliers of generation generally required interconnections to serve their customers, and as a result, the FERC has had to address its jurisdiction and cost recovery issues for these generators' interconnection facilities.

2. The FERC's Jurisdiction over Interconnections

The regulatory treatment of generator interconnection costs began to change at the same time that the legislative and regulatory changes described above started to encourage and embrace a competitive electric generation market.

In the years immediately after PURPA was enacted, utilities were unaccustomed to dealing with interconnection of third-party-owned generation and handled interconnection issues in an inconsistent manner. In many cases, an interconnecting utility required competitive generators to sign stand-alone interconnection agreements. However, it was not uncommon to find all interconnection matters addressed in a cursory fashion within power purchase agreements or in generic procedures and guidelines for QFs developed by some utilities. Indeed, in some instances, there was no formal agreement at all covering interconnection. Regardless of the form or existence of an agreement, utilities generally required the generator to pay for all interconnection costs, contribute ownership of certain interconnection facilities to the utility, and pay the utility annual fees for maintenance of the interconnection facilities.

Until the last decade, many utilities did not file interconnection agreements with the FERC because they questioned the FERC's jurisdiction over interconnection agreements.⁴² In the early 1990s, a series of FERC orders clarified that its jurisdiction extended to all interconnection agreements with IPPs because they related to the provision of jurisdictional transmission service. Accordingly, such interconnection agreements are required to be filed with, and accepted or approved by, the FERC.⁴³ With respect to interconnection

41. Table 8.1: Electricity Overview, 1949 – 2001 available at <http://www.eia.doe.gov/emeu/aer/txt/tab0801.htm> (last visited Sept. 28, 2002). Note that the electricity produced by non-utility power producers for 1978 was estimated by subtracting the amount of electricity generated from utility sources in 1978 from the total amount of electricity produced in 1978 from all sources.

42. *Florida Power Corp.*, 58 F.E.R.C. ¶ 61,161 (1992), *reh'g denied*, 60 F.E.R.C. ¶ 61,003 (1992), *supplemented*, 61 F.E.R.C. ¶ 61,063 (1992); *Western Mass. Elec. Co.*, 63 F.E.R.C. ¶ 61,039 (1993); *Western Mass. Elec. Co.*, 63 F.E.R.C. ¶ 61,222 (1993); *Alabama Power Co.*, 63 F.E.R.C. ¶ 61,309 (1993).

43. *Prior Notice and Filing Requirements Under Part II of the Federal Power Act*, 64 FERC

agreements with QFs, if the purchasing utility is directly connected to the QF, PURPA and the FERC's regulations thereunder exempt the interconnection facilities from the FERC's jurisdiction. However, if the purchasing utility is not directly interconnected with the QF (*i.e.*, the interconnecting utility transmits the QF's output to other purchasers), then the interconnection is jurisdictional and the interconnection agreement needs to be filed with, and approved or accepted by, the FERC.⁴⁴

3. The FERC's Regulatory Treatment of Interconnection Costs

After the FERC clarified its jurisdiction, it considered interconnection issues only on a case-by-case basis as transmission owners filed interconnection agreements.⁴⁵ The resulting orders are often highlighted: (1) the distinction between transmission service and interconnection service; and (2) the distinction between interconnection facilities and network or system upgrades.⁴⁶

As noted above, the FERC indicated in Order No. 888 that interconnection was part of transmission service, but the *pro forma* tariff did not address interconnection. Only after additional orders did the FERC clarify the relationship between open access transmission service and open access interconnection. In 2000 the FERC stated that: "[i]nterconnection is an element of transmission service and is already required to be provided under our *pro forma* tariff. This is true whether the interconnection request is tendered concurrently with the request for transmission service or in advance of a request for a specific transmission service."⁴⁷

Further, the FERC determined that interconnection in and of itself does not confer transmission rights from an interconnecting generation facility.⁴⁸ Following *Tennessee Power*, several utilities filed interconnection procedures to clarify the process of obtaining transmission service.⁴⁹

The FERC also adopted a relatively straightforward test to distinguish between interconnection facilities and network or system upgrades. Interconnection or direct assignment facilities are those facilities needed to actually connect a power plant to the grid (*i.e.*, those facilities between the generator and the grid). Network or system upgrades are all those facilities at or

¶ 61,139 (1993) [hereinafter *Prior Notice and Filing Requirements*]; see also *Florida Power Corp.*, 58 FERC ¶ 61,161 (1992).

44. *Prior Notice and Filing Requirements*, *supra* note 43, at 61,991-992.

45. Recently, however, the FERC decided in the interest of clarity to address these issues in a single, generic proceeding. *Interconnection Rulemaking*, *supra* note 1.

46. *Id.* Naturally, one of the disputes that arose between utilities and generators was whether facilities were direct assignment facilities or system upgrades. For example, in *Western Mass.*, the FERC ordered a hearing to determine which facilities represented the incremental cost of grid expansion and which facilities constituted non-grid facilities proper for direct assignment to a QF. *Western Mass.*, 63 F.E.R.C. ¶ 61,039; 64 F.E.R.C. ¶ 63,028 (1993) (initial decision); 77 F.E.R.C. ¶ 61,268 (1996) (affirming and reversing initial decision in part).

47. *Tennessee Power Co.*, 90 F.E.R.C. ¶ 61,238 (2000), *reh'g denied*, 91 F.E.R.C. ¶ 61,271 (2000).

48. *Arizona Pub. Serv. Co.*, 94 F.E.R.C. ¶ 61,027 (2001); 96 F.E.R.C. ¶ 61,005 (2001).

49. See generally *Consumers Energy Co.*, 95 F.E.R.C. ¶ 61,233 (2001), *reh'g denied*, 96 F.E.R.C. ¶ 61,132 (2001); 94 F.E.R.C. ¶ 61,027.

beyond the point where the generator connects to the grid and include improvements to a utility's transmission system that are required to accommodate a new generator.⁵⁰

With respect to direct assignment facilities, the FERC determined that a utility may always charge a competitive generator directly for the full costs associated with interconnecting its facility to the utility's transmission system.⁵¹ In addition, a utility may charge a generator to recover its operation and maintenance expenses for direct assignment facilities.⁵² Finally, given that a generator pays the full costs, direct assignment facilities may not be included in a utility's rate base.⁵³

The FERC's pricing policy for system upgrades stems from its traditional view of the transmission grid as a single piece of equipment. As a result, the FERC's long-standing policy provides that grid facilities, including system upgrades, cannot be directly assigned to the generator.⁵⁴

To recover the costs of a system upgrade (*i.e.*, a grid facility added to accommodate a generator or transmission customer), the FERC developed a transmission pricing policy that is still in use today, known as "or pricing." Under "or pricing," a transmission provider is permitted to charge a transmission customer a transmission rate that recovers the higher of: (1) embedded cost (*i.e.*, a rolled-in rate for transmission that includes system upgrade costs); or (2) the incremental cost of the system upgrade (*i.e.*, the revenue requirement for the system upgrade divided by the generator's units of service).⁵⁵ Operation and

50. *Energy Gulf States, Inc.*, 98 F.E.R.C. ¶ 61,014 (Jan. 11, 2002).

51. *Pennsylvania Elec. Co.*, 60 F.E.R.C. ¶ 61,034, at 61,129 n.49 (1992); *see also Western Mass. Elec. Co.*, 63 F.E.R.C. ¶ 61,039, n.9 (1993).

52. *Southern Co. Serv., Inc.*, 99 F.E.R.C. ¶ 61,249 (2002); *Duke Energy Corp.*, 95 F.E.R.C. ¶ 61,279 (2001).

53. *See generally Appalachian Power Co.*, 63 F.E.R.C. ¶ 61,151 (1993); *Public Serv. Co. of Colo.*, 62 F.E.R.C. ¶ 61, 013 (1993).

54. *Public Serv. Co. of Colo.*, 59 F.E.R.C. ¶ 61,311 (1992), *reh'g denied*, 62 F.E.R.C. ¶ 61, 013 (1993).

55. *Id.* One of the early cases addressing "or pricing" was *Pennsylvania Electric Co.*, 58 F.E.R.C. ¶ 61,278 (1992). Penntech was a QF that agreed to sell its electric output to Niagara Mohawk Power Corporation (Niagara Mohawk). Penntech was located within Pennsylvania Electric Company's (Penelec) service territory and Penntech entered into an agreement with Penelec to facilitate the interconnection of its facility and the transmission of power to Niagara Mohawk. Under the parties' agreement, Penntech was to design, construct and install, at its own expense: (a) a 7.5 mile 115-kV transmission line from its qualifying facility to Penelec's substation; and (b) the interconnection facilities necessary to interconnect the 7.5 mile line to Penelec's transmission system. In addition, the same agreement provided for Penelec's provision of firm transmission to Niagara Mohawk for a twenty-year period to accommodate Penntech's sales to Niagara Mohawk. Penelec's transmission pricing proposal would have charged rates based on a 100% contribution to its fixed costs (*i.e.*, rolled-in rates) plus compensation to the utility's native load customers for the incremental cost of serving Penntech. Accustomed to the regime where third-party owned generators paid all costs for interconnection, Penntech intervened and supported Penelec's rate proposal. Despite the support by both parties, the FERC rejected Penelec's proposed pricing. The FERC stated that important policy considerations caused it to reach a decision contrary to that supported by the parties, and the FERC reiterated its "or pricing" by determining that Penelec could charge the higher of (i) the utility's rolled-in transmission rate or (ii) the utility's validated "opportunity cost" of serving the QF at the expense of native load, capped at the incremental cost of expanding the transmission grid to accommodate the QF. *Pennsylvania Elec. Co.*, 58 F.E.R.C. ¶ 61,278 (1992).

maintenance expenses for the system upgrade are not permitted to be directly assigned but instead are to be recovered through transmission rates.⁵⁶

In recent years, generators began to seek interconnection service before securing any rights to transmission service.⁵⁷ Because these generators were not requesting transmission service, the transmission provider had difficulty using "or pricing" to facilitate its recovery of the cost of system upgrades. Some transmission providers proposed that generators bear the entire cost of system upgrades. The FERC, however, took a slightly different approach. While the FERC permitted transmission providers to charge generators for the costs of system upgrades, the FERC also required the transmission providers to give generators transmission credits to reimburse them for the cost of the system upgrades.⁵⁸ In addition, the FERC also held that these credits for future transmission service must include interest on the amount the generator pays for the upgrades, with interest commencing from the date the generator provides funds to the transmission provider and ceasing when the transmission provider completely reimburses the generator.⁵⁹ The rate of interest is to be consistent with FERC regulations, which currently require a rate equal to an average prime rate.⁶⁰ Moreover, the FERC has stated in several cases that such credits are assignable to any customer taking service from the generator.⁶¹

On April 24, 2002, the FERC issued a notice of proposed rulemaking in which it proposed to amend its regulations by requiring each public utility to file a standardized interconnection agreement and procedures.⁶² Through this rulemaking proceeding, the FERC intends to address a variety of issues surrounding interconnection, to remove some of the uncertainty that has historically plagued interconnections, and to facilitate further development of competitive generation alternatives. The rulemaking included a tax indemnity

56. *Boston Edison Co.*, 99 F.E.R.C. ¶ 61,241 (May 31, 2002); *Boston Edison Co.*, 98 F.E.R.C. ¶ 61,200 (Feb. 27, 2002); *Western Mass. Elec. Co.*, 77 F.E.R.C. ¶ 61,268 (1996).

57. For example, a proposed generating project that does not have its electric output committed under a long-term PPA would not necessarily seek transmission service with its request for interconnection, because it would not yet know what degree or type of transmission will be needed or appropriate.

58. See generally *Entergy Gulf States, Inc.*, 98 F.E.R.C. ¶ 61,014 (Jan. 11, 2002), *reh'g denied*, 99 F.E.R.C. ¶ 61,095 (Apr. 25, 2002); *Southern Co. Serv., Inc.*, 94 F.E.R.C. ¶ 61,131 (2001). Note that the FERC has permitted certain regional transmission groups to award financial rights offsetting transmission congestion in lieu of transmission credits. *PJM Interconnection L.L.C.*, 87 F.E.R.C. ¶ 61,299, 62,204 (1999), *reh'g denied*, 89 F.E.R.C. ¶ 61,186 (1999). The FERC, however, has rejected as premature, contract language that would permit a transmission provider to convert transmission credits to the applicable financial rights if the transmission provider participates in a regional transmission group that ultimately adopts such a system. *Entergy Louisiana, Inc.*, 99 F.E.R.C. ¶ 61,199 (May 21, 2002) (holding that the outcome of this issue also depended on the results of the FERC's Interconnection Rulemaking).

59. *American Elec. Power Serv. Corp.*, 91 F.E.R.C. ¶ 61,308 (2000); *Florida Power & Light*, 98 F.E.R.C. ¶ 61,276 (Mar. 14, 2002).

60. 98 F.E.R.C. ¶ 61,276 (indicating that the applicable interest rate is to be consistent with 18 C.F.R. § 35.19(a)(2)).

61. *American Elec. Power Serv. Corp.*, 97 F.E.R.C. ¶ 61,207 (2001); *Arizona Pub. Serv. Co.*, 95 F.E.R.C. ¶ 61,070 (2001); *Duke Energy Corp.*, 94 F.E.R.C. ¶ 61,187 (2001); *Virginia Elec. & Power Corp.*, 93 F.E.R.C. ¶ 61,207 (2000); *Carolina Power & Light Co.*, 93 F.E.R.C. ¶ 61,032 (2000).

62. *Interconnection Rulemaking*, *supra* note 1.

provision in the proposed standard interconnection agreement in case the transfers of interconnection facilities or system upgrades were taxable.⁶³

III. TAX POLICY OF NONSHAREHOLDERS CONTRIBUTIONS TO CAPITAL

The IRS has issued several notices, that define certain “safe harbor” transactions in which the transfer of, or the payment for, interconnection facilities is not taxable to a utility at the time that a generator connects to the grid. The latest of these notices, IRS Notice 2001-82,⁶⁴ extends the safe harbor to interconnections of stand-alone power generators. But the nature of a safe harbor is that, in return for certainty, the boundaries of its scope are precise. The IRS notices do not provide answers for several aspects that have recently developed in connecting to the grid. Analyzing the interconnection issue in the context of the tax treatment of nonshareholder contributions to the capital of railroads and utilities over almost eight decades helps to provide an analytical framework for looking at issues that are not answered by the safe harbors.

This historical approach reveals the tension between pure tax policy, as asserted by both the IRS in many litigated cases and the Treasury Department in testimony before congressional committees, and the public policy surrounding the necessary expansion of utilities and the services that they provide. The facts of the cases, as well as the legislative history of section 118 of the Internal Revenue Code,⁶⁵ chronicle the growth of industrial and residential expansion in the United States. With that expansion came the demand for railroad spurs, electric lines, and water and sewer lines beyond the core cities. Given that railroad tracks, electric lines, and water and sewer lines were privately owned, the source of capital and the incentives to expand the systems to accommodate growth were all important. Whereas the public policy—or rudimentary energy policy, so to speak—overridingly favored cheap regulated rates to lower shipping and housing costs, the tax policy continued to struggle with the character of construction funded by customers who were begging to be serviced by monopolies. At issue from a tax perspective was whether the funding provided by customers constituted mere advance payments for the performance of future services, which would be taxable income, or a contribution to capital by a person with no ownership in the enterprise, which could be nontaxable.

A. Public Policy as Judicial Tax Policy: Edwards v. Cuba Railroad and Appeal of Liberty Light and Power Co.

As early as 1925, the Supreme Court tackled the topic of taxation of transportation subsidies. In *Edwards v. Cuba Railroad*,⁶⁶ the government of Cuba paid cash subsidies by the kilometer to a New Jersey corporation to construct and operate railroad lines around Cuba. As part of the same transaction, the Cuban government demanded that the railroad reduce the

63. *Interconnection Rulemaking*, supra note 1, at 34,209.

64. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619.

65. I.R.C. § 118 (2002).

66. *Edwards v. Cuba R.R. Co.*, 268 U.S. 628 (1925).

standard tariffs by one-third for public employees and private first-class riders, as well as transport troops in war time at a special rate.⁶⁷ The subsidies totaled about one-third of the cost of building the line.⁶⁸ Later, in a separate contract, the railroad accepted a second cash subsidy, as well as land, buildings, and equipment from the Cuban government to build and operate a second line, again at reduced rates for transport in certain instances.⁶⁹ The Cuban government was allowed to build telephone and telegraph stations along the railroad right of way.⁷⁰

The Court's analysis set the stage for decades to come. Holding that the subsidies were not taxable income to the railroad, the Court found that the cash payments were not for services to be rendered by the railroad in Cuba.⁷¹ Rather, the Cuban government had paid for something more ephemeral and more valuable than rate reductions; it had obtained transportation that would develop the resources of Cuba and promote settlement in other areas in the country. The subsidies were paid to reimburse the railroad for the capital expenditure of building the track that was to build the development needed by the Cuban government. Payments of this nature "[w]ere not profits or gains from the use or operation of the railroad," that is, the payments were not income under the Sixteenth Amendment.⁷²

While difficult to define conceptually, the concept of a non-taxable contribution to the capital of a private corporation by a person who is not a shareholder clearly answered a public policy need. Indeed, the Supreme Court recognized the application of the principle to the situation in the United States:

The Cuban laws and contracts are similar to legislation and arrangements for the promotion of railroad construction which have been well known in the United States for more than half a century. Such aids, gifts and grants from the government, subordinate political subdivisions or private sources,—whether of land, other property, credit or money,—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities. . . . The things so sought to be attained in the public interest are numerous and varied.⁷³

The Court clearly looked to the purpose of the transferor in making the payment. Moreover, the Court appears to have regarded the public purposes advanced by the Cuban government as evidence that there was not a payment for services to be rendered.

The next seminal case, which appeared one year later, did not involve

67. *Id.* at 630.

68. *Edwards*, 268 U.S. at 630.

69. *Id.*

70. *Edwards*, 268 U.S. at 630.

71. *Id.* at 633. The Commissioner of Internal Revenue attacked only the cash subsidies. The railroad also did not report as income the land, buildings, and equipment that it received from Cuba in the second contract, which went unchallenged. Indeed, the Court correctly equated the treatment of the cash and the in-kind payments. *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 632-33 (1925).

72. *Id.* The Court had previously interpreted the term "income" as used in the Sixteenth Amendment to mean "gain derived from capital, from labor, or from both combined," including gain from the sale of capital assets. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

73. *Edwards*, 268 U.S. at 631-32.

government subsidies.⁷⁴ In *Appeal of Liberty Light & Power Co.*, before the Board of Tax Appeals, Liberty Light was a private electric company that sold electricity in Indiana and Ohio. Its sales were regulated by the Indiana and Ohio Public Utilities Commissions.⁷⁵ While it had to provide electric service to all customers within its territory at “just and reasonable rates,” it did not have to provide electricity to customers outside its existing service territory.⁷⁶ If customers beyond the boundaries of its service territory contributed to building the new facilities required to service their area however, Liberty Light was required to accept those facilities, maintain them, and furnish service at rates set by the respective Commissions.⁷⁷ In order to induce Liberty Light to extend service to a rural area that would otherwise have been less profitable, rural customers paid a portion of the cost of the new facilities that would be used to service them. Title to these new facilities passed to Liberty Light.⁷⁸ Once the customers were provided with service they paid the municipal rates paid by regular customers, plus an additional rural electricity charge.⁷⁹

Summarily rejecting the contention that the new facilities had been contributed as payment for future services, the Board of Tax Appeals noted that the rural customers paid the regulated rates charged to municipal customers, who did not have to make any special contribution, plus an additional fee for rural service.⁸⁰ By assuming that the rates that rural customers paid for service accurately reflected the value of the service to them, the majority removed any commercial motive for their contribution of the new facilities to Liberty Light. The Board then struggled with the concept of income within the meaning of the Sixteenth Amendment in determining whether “gain [was] derived from capital, from labor, or from both combined.”⁸¹ Quoting extensively from the lower and Supreme Court decisions in *Edwards v. Cuba Railroad* as to the nature of income under the Sixteenth Amendment, the Board determined that the contributions of the new facilities were not derived from capital or labor but from increased capital. The contributions were, therefore, not income within the meaning of the Sixteenth Amendment and not taxable.⁸²

The dissent in *Liberty Light* argued that the contributions were clearly payments for services, specifically that “[t]here was nothing altruistic in the motive which prompted these prospective customers to finance the extension. They needed service and they were willing to pay for it.”⁸³ It distinguished *Edwards v. Cuba Railroad* on the grounds that the latter case involved government subsidies, not payments from private customers to a private, profit-

74. *Appeal of Liberty Light & Power Co.*, 4 B.T.A. 155 (1926).

75. *Id.* at 156.

76. *Liberty Light*, 4 B.T.A. at 156.

77. *Id.*

78. *Liberty Light*, 4 B.T.A. at 156-57.

79. *Id.* at 158.

80. *Appeal of Liberty Light & Power Co.*, 4 B.T.A. 155, 160 (1926).

81. *Id.* at 160 (quoting *Stratton's Independence Ltd., v. Howbert*, 231 U.S. 399, 415 (1913) and *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)).

82. *Liberty Light*, 4 B.T.A. at 164.

83. *Id.* at 164.

making company to induce it to expand its ordinary business.⁸⁴

Despite the persuasive arguments of the dissent, which articulated the tax policy driving the government's litigating position, the majority opinion in *Liberty Light* was followed with scant discussion for almost thirty years, as courts applied it mechanically to customer financed railroad tracks,⁸⁵ electric transmission lines,⁸⁶ and water mains.⁸⁷ In several instances, the customers' contributions were refundable out of the income produced by the contribution during a set time period.⁸⁸ In *Tampa Electric*, customers were charged \$30 for each pole in the extension line built to service them, but they were reimbursed at a designated rate if other customers signed up to use the line. Regardless of the reimbursement arrangement, the contributions of these facilities were routinely held to be nontaxable because they were not income.⁸⁹ Since the contributions were not income, they had to be contributions to capital by nonshareholders.

B. Tax Policy Emerges: *Detroit Edison Co. v. Commissioner*

The *Liberty Light* line of cases had an important collateral effect, which led to the next round of litigation and policy statements in this area. Under the 1939 Internal Revenue Code, if property were contributed to a corporation as a contribution to capital, the corporation succeeded to the contributor's basis in the property.⁹⁰ As a logical extension of the holdings of the *Liberty Light* cases,

84. *Liberty Light*, 4 B.T.A. at 164.

85. *Baltimore & Ohio R.R. Co. v. Comm'r*, 30 B.T.A. 194 (1934) (payments by shippers for spur with reimbursement schedule not taxable, however payments by Sanitary District of Chicago to railroad to relocate tracks were taxable; result depends upon purpose of transfer); *Southern Ry. Co. v. Comm'r*, 27 B.T.A. 673 (1933) (spur tracks paid for by customers with reimbursement at 5% of revenue from goods shipped over the track not taxable); *Union Pac. R.R. Co. v. Comm'r*, 26 B.T.A. 1126 (1932) (facilities built by customers for railroad for which they were reimbursed at a specific rate per carload that was shipped during a specified period over the line and anything not reimbursed remained with the railroad not taxable); *Kauai Ry. Co. v. Comm'r*, 13 B.T.A. 686 (1928) (amounts paid by shipper with title in railroad for railroad spur between warehouse for sugar and main track not taxable); *Great N. Ry. Co. v. Comm'r*, 8 B.T.A. 225 (1927) (spur tracks and form crossings paid for by customers not taxable).

86. *Tampa Elec. Co. v. Comm'r*, 12 B.T.A. 1002 (1928) (customers paid for electric extension lines and were reimbursed if other customers used the line, not taxable); *El Paso Elec. Ry. Co. v. Comm'r*, 10 B.T.A. 79 (1928) (customers paid one-third of the cost of electric power line extensions to their premises, not taxable); *Rio Elec. Co. v. Comm'r*, 9 B.T.A. 1332 (1928) (electric transmission lines paid by rural residents for their own connections and reimbursed by electric company only if new customer joins line, not taxable).

87. *Fairfax County Water Auth. v. United States*, 223 F. Supp. 620 (E.D. Va. 1963) (customers paid frontage and service charges to connect to water mains and have meters installed, not taxable). While *Fairfax County Water Auth.* did not actually cite *Liberty Light*, it applied the same reasoning as the *Liberty Light* court.

88. *Tampa Elec. Co.*, 12 B.T.A. 1002 (1928).

89. *Baltimore & Ohio R.R. Co.*, 30 B.T.A. at 200; *Southern Ry. Co.*, 27 B.T.A. at 81; *Union Pac. R.R. Co.*, 26 B.T.A. at 1129; *Tampa Elec. Co.*, 12 B.T.A. at 1006; *El Paso Elec. Ry. Co.*, 10 B.T.A. at 81; *Rio Elec. Co.*, 9 B.T.A. at 1334-1335.

90. I.R.C. § 113(a)(8)(B) (1939). Section 113(a) stated that the basis of property was the cost of such property unless an exception applied. Section 113(a)(8) provided:

If the property was acquired after December 31, 1920, by a corporation . . .

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of

railroads and utilities excluded the cost of the contributed property from income as contributions to capital, but depreciated the full cost of the property, which had been paid for by the contributing customers. The second benefit, depreciating the cost of property that the corporation had not paid for, was attacked by the Commissioner.

In 1943, the depreciation benefit reached the Supreme Court.⁹¹ In *Detroit Edison*, the Detroit Edison Company received cash subsidies from customers to build extension lines. Although some of the subsidies were refundable, the case dealt with those amounts that would never be refunded.⁹² Undoubtedly relying upon prior case law, the electric company added the subsidies to surplus but did not report them as income.⁹³ The Commissioner did not challenge the income exclusion, but maintained that Detroit Edison had to reduce the depreciable basis of the property by the amount of cash contributed by customers. In a measured way, the Court agreed with the Commissioner that the depreciable basis of the property should be the taxpayer's actual cost for the property.⁹⁴ The Court then addressed Detroit Edison's argument that it had a carryover basis in the property because the customers had, in effect, contributed the facilities to its capital. The Court's dicta changed the landscape:

It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transaction neither in form nor in substance bore such a semblance.

The payments were to the customer the price of the service. The receipts have gone, so far as here involved, to add to the Company's surplus. They have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, . . . holding that under the circumstances of that case a government subsidy to induce railroad construction was not income. But it does not follow that the Company must be permitted to recoup through untaxed depreciation accruals on investment it has refused to make.⁹⁵

This judicial assault on the purportedly altruistic motives of the transferring customers did not escape Congressional notice. In the extensive revision to the Internal Revenue Code in 1954, Congress added section 118 to explicitly exclude contributions to capital from the income of a corporation.⁹⁶ In the

loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Id.

91. *Detroit Edison Co. v. Comm'r.*, 319 U.S. 98 (1943).

92. *Id.* at 100.

93. *Detroit Edison*, 319 U.S. at 100.

94. *Id.* at 102.

95. *Detroit Edison*, 319 U.S. at 102-103.

96. I.R.C. § 118 (1954) as initially enacted provided:

Contributions to the Capital of a Corporation.

(a) General Rule. In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Cross Reference. For basis of property acquired by a corporation through a contribution to its capital, see section 362.

legislative history to the original enactment of section 118, the section was described as codifying the court decisions: "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."⁹⁷ This statement echoes the public benefit rationale of *Edwards* and *Brown Shoe Company*.⁹⁸ The committee reports add: "[B]ecause 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."⁹⁹ Still focusing on the motives of the contribution, the committee reports contemplated that an indirect benefit to the contributor would not make the contribution taxable.

The 1954 Code provided a zero basis for property that was contributed to capital by nonshareholders.¹⁰⁰ This effectively eliminated (albeit prospectively) the problem of depreciating the full cost of property that the taxpayer corporation did not pay.

In regulations under the 1954 Code, the Treasury Department retained the distinction drawn in *Detroit Edison* between nonshareholder, nontaxable contributions to capital, and payments for services:

[T]he exclusion [from income of nonshareholder contributions to capital] applies to the value of land or other property contributed to a corporation by a governmental

Id.

97. H.R. REP. NO. 83-1337, at 17 (1954); S. REP. NO. 83-1622, at 18 (1954).

98. *Brown Shoe Co. v. Comm'r*, 339 U.S. 583 (1950). Seven years after *Detroit Edison*, the Court decided *Brown Shoe*. In *Brown Shoe*, community groups paid the taxpayer as an inducement for the location or expansion of factory operations in their communities. The Court concluded that the assets transferred by the community groups were non-taxable contributions to capital of the private company because they were not compensation for specific services rendered, did not constitute gifts, and the only expectation of the groups was to advance the community at large. The Court did not overrule *Detroit Edison*, but instead distinguished it based on an analysis of the purposes behind the respective transfers. *Id.* at 591.

99. H.R. REP. NO. 83-1337, at 17 (1954); S. REP. NO. 83-1622, at 18 (1954).

100. I.R.C. § 362(c) (1954). Section 362(c) initially provided:

(c) Special rules for certain contributions to capital.

(1) Property other than money. Notwithstanding subsection (a)(2), if property other than money—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) Money. Notwithstanding subsection (a)(2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

Id.

unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or 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 for the purpose of inducing the taxpayer to limit production.¹⁰¹

The purpose of customers in paying for grid expansion was difficult to characterize where the expansion serviced the customers. Despite the wish of Congress to codify the case law, the issue of income inclusion had not yet been resolved.

C. Income Inclusion

After the 1954 Code, the case law continued to develop the nuances of when a customer payment would be considered income or a nontaxable contribution to capital by a nonshareholder. In 1958, the Tax Court and the Third Circuit finally applied the dicta in *Detroit Edison* and refused to follow *Liberty Light* and its progeny, holding that customer contributions were taxable as payments for services rendered.¹⁰²

Teleservice presented a mixed blend of motivations. The taxpayer was a privately owned, for-profit Pennsylvania corporation that was incorporated in order to bring television reception to the valley communities of Wilkes-Barre and Kingston. It was not a regulated public utility. Teleservice built a community antenna, based on new technology, because signals from conventional television antennas were blocked by the mountains surrounding these towns.¹⁰³ To spread the risk that the technology would not work, the subscribers to the system had to pay an initial amount towards the installation of the system, in addition to monthly service charges.¹⁰⁴ Residential and commercial customers were charged different initial fees based upon the company's estimate of their ability to pay.¹⁰⁵ The installation fee was personal to the customer, so that if the customer moved within the area, he did not pay another fee, although another occupant of his house or business location did.¹⁰⁶

As could be expected, Teleservice argued that its business benefited the towns by bringing them television by way of an unknown technology and that it had used all initial contributions "in aid of capital construction."¹⁰⁷ In light of *Detroit Edison*, the court characterized the payments from the customers as payments for future services, because without the payment, the customer would not benefit from the community's access to television.¹⁰⁸ The Third Circuit explicitly rejected the *Liberty Light* line of cases (including the regulated public

101. Treas. Reg. § 1.118-1 (1956).

102. *Teleservice Co. of Wyo. Valley v. Comm'r*, 254 F.2d 105 (3d Cir. 1958), *aff'g* 27 T.C. 722 (1957).

103. *Id.* at 107.

104. *Teleservice Co.*, 254 F.2d at 107.

105. *Id.*

106. *Teleservice Co.*, 254 F.2d at 107.

107. *Id.* at 109.

108. *Teleservice Co. of Wyo. Valley v. Comm'r*, 254 F.2d 105, 111 (3d Cir. 1958).

utility cases), finding them indistinguishable factually from the case at hand.¹⁰⁹

The IRS limited the *Teleservice* case to companies that were not regulated public utilities and declared that any change in position with respect to the taxability of contributions to regulated public utilities would be prospective only.¹¹⁰ In Rev. Rul. 58-555, the IRS drew the distinction between regulated and unregulated utilities, which the Third Circuit and the Tax Court had expressly refused to draw.¹¹¹

Inserting itself into the wedge between the judicial interpretation of *Detroit Edison* and the administrative position adopted by the IRS in Rev. Rul. 58-555, the Supreme Court in 1973 tried to define a nonshareholder contribution to capital.¹¹² Like *Detroit Edison*, *Burlington* involved the depreciation of nonshareholder contributions to capital that were paid before the effective date of the 1954 Code. This time, to promote highway safety, the subsidies were governmental—state and federal payments to railroads that amounted to 90% of the cost of construction of highway undercrossings and overcrossings; crossing signals, signs, and floodlights; and jetties and bridges.¹¹³ Although the railroad benefited by the greater efficiency of the rebuilt track system, the railroad would not have made the changes on its own. Considering the governmental source of the funds and the public purpose of national highway safety, which was not part of the railroad's business, the railroad excluded the subsidies from income, which was not challenged. In a tax refund suit, however, the railroad claimed that it should be entitled to depreciate the full cost of the facilities because the subsidies were nonshareholder contributions to capital.¹¹⁴

The reasoning of *Burlington* is questionable, considering the result-oriented opinion that strained to deny the railroad a depreciation deduction for facilities for which it had not paid. Despite the public nature of the subsidies paid to the railroad, the Supreme Court held that the subsidies were not contributions to capital for the purposes of the 1939 depreciation sections.¹¹⁵ It set aside a test based upon the intent of the transferor for the contribution, either as payment for services or as a nonshareholder benefit.¹¹⁶ The Court tried to identify contributions to capital, not by the intent of the transferor, but by whether the transferred property became part of the transferee's capital structure.¹¹⁷ The

109. *Id.* at 112.

110. Rev. Rul. 58-555, 1958-2 C.B. 25, *revoked by* Rev. Rul. 75-557, 1975-2 C.B. 33.

111. *Id.*

112. *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401 (1973).

113. *Id.* at 403.

114. *Burlington*, 412 U.S. at 403.

115. *Id.* at 415.

116. *Burlington*, 412 U.S. at 415. In *Brown Shoe*, the contributed funds were intended to benefit not only the transferors, but the transferee manufacturer as well. *Brown Shoe Co. v. Comm'r*, 339 U.S. 583, 591 (1950). In *Detroit Edison*, because of regulated rates, the anticipated revenue from the service lines to the customers would not have warranted investment by the utility itself. *Detroit Edison Co. v. Comm'r*, 319 U.S. 98, 99 (1943). The benefit to *Detroit Edison*, therefore, was marginal and the total benefit was enjoyed by the transferor customers. *Id.* After a lengthy discussion of both cases, the *Burlington* Court determined that neither *Detroit Edison* nor *Brown Shoe* had definitively answered the question of what constitutes a "contribution to capital." *Burlington*, 412 U.S. at 412.

117. *Id.* at 413.

Court examined the economic and business consequences to the transferee and defined five characteristics of nonshareholder contributions to capital. First, the contribution had to become a permanent part of the transferee's working capital structure. Second, it could not be a direct payment for specific, quantifiable services. The Court admitted that the payments in the case were not for services.¹¹⁸ Third, the payment had to be bargained for. Here, the railroad did not bargain for the payment and would not have built the facilities at all until forced by the government.¹¹⁹ Fourth, the transferred assets had to benefit the transferee foreseeably in an amount commensurate with its value. Since the facilities built by the railroad were only somewhat helpful to its business, they did not contribute "materially" to the railroad's business.¹²⁰ Lastly, the asset ordinarily had to be employed to produce additional income. Although the facilities were used in the railroad's business, their benefit to the railroad did not approach their cost, and they did not contribute substantially to the production of income.¹²¹

Considering that the government subsidies in *Burlington* were not payments for services, the result of the Court's opinion was to cast the subsidies into a new category that was neither income nor a contribution to capital. The dissent argued that the pure intent test of *Detroit Edison* and *Brown Shoe* should not be abandoned, especially in light of the 1954 legislative changes that had prospectively given nonshareholder contributions to capital a zero basis.¹²²

Since the Court's second criterion for a nonshareholder contribution to capital was that the payment could not be for services, it retained the broad distinction that had served in *Edwards v. Cuba Railroad* and *Detroit Edison*. Its holding further refined the characteristics of a transfer that were needed to qualify as a contribution to capital once it was determined that the payment was not for services.¹²³

Despite the awkward formulation of the *Burlington* decision, it served as the occasion for the IRS to reconsider the distinction between regulated public utilities and unregulated companies that it had drawn in Rev. Rul. 58-555.¹²⁴ In Rev. Rul. 75-557, the Service revoked Rev. Rul. 58-555 prospectively for amounts paid by customers to regulated public utilities on and after February 1, 1976. The revenue ruling held that a connection fee paid by a customer to a water utility for constructing and installing a service line and a water meter to the main water line was taxable to the utility.¹²⁵ With the congruence of the administrative position and the case law as to the tax treatment of payments for services, the debate turned to Congress.

118. *Burlington*, 412 U.S. at 413.

119. *Id.* at 414.

120. *Burlington*, 412 U.S. at 414.

121. *Id.* at 415.

122. *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401, 425-426 (1973).

123. *Id.* at 413-414.

124. Rev. Rul. 75-557, 1975-2 C.B. 33.

125. *Id.* (adopting the five characteristics for nonshareholder contributions to capital set forth in *Chicago, Burlington*).

D. Public Policy as Legislative Tax Policy

Checked as the development of the case law, the Congressional responses to the taxation of nonshareholder contributions to capital have been contradictory. The first effort after the 1954 enactment of section 118 was a limited but straightforward response to Rev. Rul. 75-557. Although the legislative change addressed only water and sewage disposal utilities, the reasons for change were general enough to cover all utilities:

The effect of the recent IRS ruling [Rev Rul. 75-557] was to increase substantially the taxes of those utilities which had previously treated all contributions in aid of construction as nontaxable contributions to capital. These increased taxes would have ultimately resulted in higher charges to utility customers. Since such increased charges must be approved by public utility commissions, the working capital of the utilities could have been substantially reduced resulting in delays in furnishing service and curtailment of expansion of service.¹²⁶

The Tax Reform Act of 1976 introduced the contribution in aid of construction which was a new category of nontaxable, nonshareholder contributions to capital.¹²⁷ In order to qualify as a contribution in aid of

126. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 635 (Comm. Print 1976).

127. The Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1841 at § 2120, added new subsection (b) to I.R.C. § 118. New § 118(b) provided:

(b) Contributions in Aid of Construction.

(1) GENERAL RULE. For purposes of this section, the term 'contribution to the capital of the taxpayer' includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services if—

(A) such amount is a contribution in aid of construction,

(B) where the contribution is in property which is other than water or sewerage disposal facilities, such amount meets the requirements of the expenditure rule of paragraph (2), and

(C) such amounts (or any property acquired or constructed with such amounts) are not included in the taxpayer's rate base for rate-making purposes.

(2) EXPENDITURE RULE. An amount meets the requirements of this paragraph if—

(A) an amount equal to such amount is expended for the acquisition or construction of tangible property described in section 1231(b)—

(i) which was the purpose motivating the contribution, and

(ii) which is used predominantly in the trade or business of furnishing water or sewerage disposal services,

(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

(C) accurate records are kept of the amounts contributed and expenditures made on the basis of the project for which the contribution was made and on the basis of the year of contribution or expenditure.

(3) DEFINITIONS. For purposes of this section—

(A) Contribution in Aid of Construction— The term 'contribution in aid of construction' shall be defined by regulations prescribed by the Secretary; except that such term shall not include amounts paid as customer connection fees (including amounts paid to connect the customer's property to a main water or sewer line and amounts paid as service charges for starting or stopping services).

(B) Predominantly. The term 'predominantly' means 80 percent or more.

(C) Regulated Public Utility. The term 'regulated public utility' has the meaning given such

construction, the amounts had to be received by a water or sewage disposal regulated utility that was required to serve the public. The amounts could not be included in rate base by the regulatory authority and they had to be used for "qualified expenditures" within two taxable years of receipt.¹²⁸

The specter of payment for services, however, still hovered over these changes in precisely the form taken in Rev. Rul. 75-557. Throughout the legislative history to the 1976 act, the Treasury was given authority to prescribe rules as to what constituted a nontaxable contribution in aid of construction. At the same time, the congressional committees included specific examples of what would be nontaxable. The Senate Committee Report included the following nontaxable example: "A customer pays a fee to reimburse the utility for lines, valves, pipes, or meters, or a customer constructs his own lines which are turned over to the water or sewage disposal utility."¹²⁹

This example was omitted from the Conference Report and the Joint Committee Explanation. Instead, those reports stated:

[N]ontaxable treatment is not accorded to customer connection fees. Customer connection fees include any payments made by a customer to the utility for the cost of installing the connection between the customer's property and the utility's main water or sewer lines (including the cost of meters and piping) and any amounts paid as service charges for stopping or starting service.¹³⁰

The Joint Committee Explanation reiterated this treatment: "However, the Congress also believed that nontaxable treatment should not be accorded to customer connection fees and to contributions to utilities which are not required to serve the general public."¹³¹

In 1978, Congress considered extending the nontaxable treatment of contributions in aid of construction (excluding connection fees) to regulated public gas and electric utilities. In testimony before the Ways and Means Committee, Daniel Halperin, the Tax Legislative Counsel for the Treasury Department, broke down the policy behind contributions in aid of construction into two parts.¹³² First was the question of whether the tax policy of these

term by section 7701(a)(33); except that such term shall not include any such utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(4) DISALLOWANCE OF DEDUCTIONS AND INVESTMENT CREDIT; ADJUSTED BASIS. Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of any property acquired with contributions in aid of construction to which this subsection applies shall be zero.

I.R.C. § 118(b) (1976).

128. *Id.*

129. S. REP. NO. 94-938, at 435 (1976).

130. H.R. CONF. REP. NO. 94-1515, at 637 (1976); *see also* STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 635, 637 (Comm. Print 1976).

131. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 635, 636 (Comm. Print 1976).

132. *Revenue Act of 1978: Hearing on H.R. 13511 and H.R. 11741 Before the House Comm. on Ways and Means*, 95th Cong. 5-6, 9-10 (1978) (statement of Daniel I. Halperin, Tax Legislative Council, Office of Tax Policy, Department of the Treasury) [hereinafter *Hearing on H.R. 13511 and H.R. 11741*].

transfers was correct. The Treasury maintained that they constituted payments for services but that they could be viewed as loans by customers to the utility that were paid back through reduced rate charges.¹³³ Since this arrangement did not have a fixed maturity date or any obligation on behalf of the utility to repay the full amount, the loan analogy was not completely satisfactory. More importantly, the interest element on the loan went untaxed in the form of an unquantified rate reduction to the customer. The Treasury recommended repeal of all nontaxable contributions in aid of construction.¹³⁴ The second part of the policy analysis assumed that the tax treatment survived and involved which utilities should benefit from nontaxable contributions in aid of construction.¹³⁵ This was clearly a political judgment. The revenue implications did not deter Congress from broadening nontaxable treatment to cover contributions in aid of construction that were made to regulated gas and electric utilities retroactively to January 31, 1976.¹³⁶ Nevertheless, the legislative history confirmed that customer connection fees were to continue to be taxable.

Other than tightening the statute to allow the IRS to better audit the qualified expenditure provisions,¹³⁷ Congress allowed water, sewer, gas, and electric utilities to exclude contributions in aid of construction until 1986. Then, in the Tax Reform Act of 1986,¹³⁸ the legislators had a change of heart and belief.

The Congress believed that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility. The Congress believed that prior law allowed amounts that represented prepayments for services to be received by corporate regulated public utilities without the inclusion of such payments in gross income. Accordingly, the Act repeals the prior law treatment and requires the recipient utility to include the value of such contributions in income at the time of their receipt . . .¹³⁹

All utilities were to include in income the fair market value of the property transferred.¹⁴⁰ The value of the property was to be determined under classic tax principles as the price that a willing buyer and a willing seller would reach,

133. *Id.* at 10.

134. *Hearing on H.R. 13511 and H.R. 11741, supra* note 132, at 10.

135. *Id.*

136. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (amending I.R.C. § 118(b)(3)(C) (1978)).

137. In 1984, Congress added a new § 118(c), which extended the statute of limitations for the assessment of any deficiency and any ancillary adjustments attributable to any contribution in aid of construction to three years from the date that the Secretary is notified by the taxpayer that the contribution has been expended in the required manner, that the taxpayer intends not to make the required expenditure, or that the taxpayer has failed to make the required expenditure. I.R.C. § 118(c) (1984).

138. I.R.C. § 118(b) as enacted in 1986 provided: "(b) Contributions in Aid of Construction Etc.—For purposes of subsection (a), the term 'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer." I.R.C. § 118(b) (1986).

139. STAFF OF JOINT COMM. ON TAXATION, 100th CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 544-545 (Comm. Print 1986).

140. *Id.* at 545.

neither being under a compulsion to buy or sell.¹⁴¹ The cost of construction, the value used by regulatory bodies, or the addition or exclusion of the property from rate base were not determinative.¹⁴²

In IRS Notice 87-82, the IRS addressed the new statutory regime.¹⁴³ Citing legislative history, the Service pointed out that transfers to utilities would not be income if they were not made in connection with the provision of services, such as where “the benefit of the public as a whole was the primary motivating factor in the transfers” and not the direct benefit of particular customers in their capacity as customers.¹⁴⁴ This dichotomy between payment for services and the altruistic motivation of the transferor hearkened back to *Edwards v. Cuba Railroad* and *Detroit Edison*,¹⁴⁵ without the further gloss of *Chicago, Burlington. Connection* fees, which had always been outside the realm of nontaxable contributions in aid of construction, were excluded from the IRS Notice.¹⁴⁶

The clean sweep of the Tax Reform Act of 1986 did not last. In 1996,¹⁴⁷

141. STAFF OF JOINT COMM. ON TAXATION, 100th CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 546 (Comm. Print 1986).

142. *Id.*

143. I.R.S. Notice 87-82, 1987-2 C.B. 389.

144. *Id.* at 389 (quoting H.R. REP NO. 99-426, at 644-45 (1985)).

145. *Edwards v. Cuba R.R. Co.*, 268 U.S. 628 (1925); *Detroit Edison Co., v. Comm’r*, 319 U.S. 98 (1943). *Brown Shoe Company, v. Comm’r*, 339 U.S. 583 (1950), also based its analysis on the purpose behind the transfer.

146. I.R.S. Notice 87-82, 1987-2 C.B. 389.

147. The current version of I.R.C. § 118(c) (2002) provides:

Special rules for water and sewerage disposal utilities.

(1) General Rule. For purposes of this section, the term ‘contribution to the capital of the taxpayer’ includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services if—

(A) such amount is a contribution in aid of construction,

(B) in the case of contribution of property other than water or sewerage disposal facilities, such amount meets the requirements of the expenditure rule of paragraph (2), and

(C) such amount (or any property acquired or constructed with such amount) is not included in the taxpayer’s rate base for rate-making purposes.

(2) Expenditure Rule. An amount meets the requirements of this paragraph if—

(A) an amount equal to such amount is expended for the acquisition or construction of tangible property described in section 1231(b)—

(i) which is the property for which the contribution was made or is of the same type as such property, and

(ii) which is used predominantly in the trade or business of furnishing water or sewerage disposal services,

(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

(C) accurate records are kept of the amounts contributed and expenditures made, the expenditures to which contributions are allocated, and the year in which the contributions and expenditures are received and made.

(3) Definitions. For purposes of this section—

(A) Contribution in Aid of Construction.— The term “contribution in aid of construction” shall be defined by regulations prescribed by the Secretary; except that such term shall not include amounts paid as service charges for starting or stopping services.

Congress revived prior law with respect to water and sewer utilities in terms reminiscent of the Cuban government.

The Congress believed that the changes made by the 1986 Act with respect to the treatment of contributions in the aid of construction to water utilities may inhibit the development of certain communities and the modernization of water and sewerage facilities.

The Small Business Act restores the contributions in aid of construction provisions that were repealed by the 1986 Act for regulated public utilities that provide water or sewerage disposal services.¹⁴⁸

The Senate Finance Committee Report noted that a nontaxable contribution in aid of construction did not include a connection fee.¹⁴⁹

The statutory framework for nontaxable, nonshareholder contributions to capital, therefore, has reverted to the state of the law in 1976; water and sewer regulated public utilities can exclude nonshareholder contributions in aid of construction paid by customers as long as the contributions are used for qualified expenditures within two years.¹⁵⁰ All other utilities must include as income any contributions in aid of construction and any other contribution by a customer or a potential customer. A nonshareholder contribution to capital made by a person who is not a customer or a potential customer, that is not for services, and that is motivated by the general welfare may be excluded from income by all groups.

E. Connection Fees

Even when water, sewer, gas, and electric utilities were able to exclude nonshareholder contributions to capital or contributions in aid of construction,¹⁵¹ connection fees remained taxable.¹⁵² Since the stakes were between nontaxable

(B) Predominantly— The term ‘predominantly’ means 80 percent or more.

(C) Regulated Public Utility— The term ‘regulated public utility’ has the meaning given such term by section 7701(a)(33); except that such a term shall not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(4) Disallowance of deductions and credits; adjusted basis. —Notwithstanding any other provision of this subtitle no deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of any property acquired with contributions in aid of construction to which this subsection applies shall be zero.

Id.

148. STAFF OF JOINT COMM. ON TAXATION, 104th CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104th CONGRESS, at 240-241 (Comm. Print 1996).

149. S. REP. NO. 104-281, at 123-24 (1996).

150. Although bills were introduced in Congress to extend the exclusion for contributions in aid of construction to electric utilities for nongeneration assets, these provisions are not included in the current energy bills, H.R. 1459 and H.R. 2431. Electric Power Industry Tax Modernization Act of 2001, H.R. 1459, 107th Cong. (1st Sess. 2001); H.R. 2431, 107th Cong. (1st Sess. 2001).

151. See generally *supra* section III. D. (tracing historical treatment of nonshareholder contributions to capital).

152. Treas. Reg. § 1.118-2 (2001) provides special rules for public utilities that provide water or sewerage disposal services. Treas. Reg. § 1.118-2(b)(3) (2001) states: “a customer connection fee is not a contribution in aid of construction . . . and generally is includable in income.” Further, it provides that the term “customer connection fee includes any amount of money or other property transferred to the utility

and taxable treatment, the issue of what constituted a connection fee was heavily litigated.¹⁵³ Several issues were clarified by case law.

The cases examined what type of connection related specifically to a customer. Payments used for transmission and distribution lines were held not to be taxable connection fees.¹⁵⁴ Customer payments for service lines, which connected an individual customer to the utility's distribution line, however, were taxable.¹⁵⁵ Charges for transformers and transformer pads between the distribution line and underground lines to individual customers were taxable, although the court based its decision on one transformer per customer and analogized transformers to meters or service lines.¹⁵⁶ A service line that had the capacity to serve more than one customer was also held to be taxable. As long as a customer was paying for its connection, it made no difference if other customers could eventually be served on that line.¹⁵⁷ On the other hand, payments for a service line that serves more than one customer of a water or sewer utility are not considered connection fees under Treasury regulations.¹⁵⁸

F. Electric Interconnections

Despite the varying public policies applied by the courts and Congress to the taxation of nonshareholder contributions to capital, the tax policy has always been that payments for services are taxable. It was with that background that the IRS approached the taxation of payments or transfers of property made by PURPA QFs.

representing the cost of installing a connection or service line . . . from the utility's main water or sewer lines to the line owned by the customer or potential customer." *Id.* When Treas. Reg. § 1.118-2(b)(3) was proposed, several commentators argued that connection and service lines should not be treated as taxable customer connection fees because, in the reenactment in 1996, the explicit taxation of customer connection fees in former section 118(b)(3)(A) had been dropped. The Service disagreed, however, citing the legislative history to the 1996 Act which explained that the changes to section 118 were intended only to restore the contribution in aid of construction provision that was repealed in 1986 for regulated public utilities that provide water or sewerage disposal services and was not intended to change the longstanding treatment of customer connection fees. T.D. 8936, 2001-9 I.R.B. 720. Thus, the final regulations continue to make taxable fees for connection and service lines, excluding them from the definition of nontaxable contributions in aid of construction. Treas. Reg. § 118-2(b)(3) (2001).

153. *Teco Energy, Inc. v. United States*, 99-2 U.S.T.C. (CCH) 50,970 (M.D. Fla. 1999) (extension of facilities charges and residential electric underground extension payments are all taxable customer connection fees; no statutory support for distinction between whether one customer or many customers could be served); *Florida Progress Corp. v. United States*, 156 F. Supp. 2d 1265 (M.D. Fla. 1998) (underground extension charges are taxable connection fees; serve only one customer even though line is capable of serving more than one customer); *Lake Superior Dist. Power Co. v. Comm'r*, 701 F.2d 695 (7th Cir. 1983) (customer connection fees for overhead line extensions to customer, transformer charges, and underground service extension charges are all taxable fees for services); *Grantham v. United States*, 1982 U.S. Dist. LEXIS 17946 (E.D. Mo. 1982) (one time fees paid by customers for sewer lines whether or not there were already sewer lines adjacent to the customers' property and whether or not the company had to extend facilities to customers' property lines, not taxable connection fees but instead nontaxable contributions to capital).

154. *Grantham*, 1982 U.S. Dist. LEXIS 17946, at *33.

155. *Lake Superior Dist. Power Co.*, 701 F.2d at 703.

156. *Id.*

157. *Florida Progress Corp.*, 156 F. Supp. 2d at 1274.

158. Treas. Reg. § 1.118-2(b)(3)(ii)(A) (2001).

In IRS Notice 88-129, the IRS separated the taxation of interconnections from the long history of contributions in aid of construction.¹⁵⁹ Contributions in aid of construction were paid to a utility by a customer in order to help the utility sell service to that customer. These payments were of a different nature than interconnection payments. PURPA QFs typically sell power to utilities rather than buy power from utilities.¹⁶⁰ Payments by qualifying facilities for interties,¹⁶¹ therefore, are generally not payments in aid of construction, even if the intertie is used to wheel power to other utility customers of the QF.¹⁶² Only where an intertie could be used both to sell power to a utility and to buy power from a utility could the old debate arise as to what constituted a payment for services. In these situations, the IRS instituted a de facto de minimis test in which the utility could not receive an interconnection tax free and sell power to the QF of more than 5% of the total power flowing over the connection in the first ten taxable years, beginning with the year the connection was placed in service.¹⁶³

Under IRS Notice 88-129 an interconnection payment will be tax-free only if three conditions are met. First, the intertie cannot be included in the utility's rate base. Second, the power purchase contract between the QF and the utility cannot be less than ten years in duration. Lastly, power flows over a "dual-use intertie" from the utility to the QF must, at the time of the transfer, be reasonably projected to meet the 5% test over the first ten years, based upon an independent engineer's report, if practicable. For these purposes, the utility can elect to exclude the year the property is placed in service.¹⁶⁴

If the power flows exceed 5% in each of any three years within any period of five consecutive taxable years, the intertie is deemed to be transferred proportionately to the utility as a contribution in aid of construction. In determining the percentage of fair market value that would be transferred, the IRS takes facts and circumstances into account, including the historic and prospective use of the intertie. In a tax-free transfer, the QF, not the utility, amortizes the cost of the intertie as an intangible asset over an appropriate period. The utility has a zero basis in the facility.

If the utility obtains tax ownership of the property, when the power purchase contract expires, the utility is considered to receive the intertie (or the

159. I.R.S. Notice 88-129, 1988-2 C.B. 541.

160. *Id.*

161. An intertie "may include new connecting and transmission facilities, or modifications, upgrades or relocations of a utility's existing transmission network." I.R.S. Notice 88-129, 1988-2 C.B. 541. In the FERC's terminology, interties generally include direct assignment facilities and network upgrades. See generally *Southwest Power Pool, Inc.* 100 F.E.R.C. ¶ 61,248 (Sept. 5, 2002); *Entergy Gulf States, Inc.*, 99 F.E.R.C. ¶ 61,095, 61,399-400 (Apr. 25, 2002).

162. *Id.*

163. I.R.S. Notice 88-129, 1988-2 C.B. 541. "If for any taxable year power flows to the Qualifying Facility exceed 5% of total power flows over the intertie, then the utility must attach a statement to this effect to its return for such taxable year. If a power supply contract subject to the provisions of this notice terminates, the utility must attach a statement to this effect to its return for the year in which the termination occurs. The notification requirements . . . apply to taxable years ending more than 180 days after December 27, 1988. *Id.*

164. I.R.S. Notice 88-129, 1988-2 C.B. 541.

proportionate part of it not yet deemed to be transferred, in the case of the 5% limit having been exceeded) in a taxable transaction equal to the fair market value of the intertie at the time of transfer, reduced by any amount paid by the utility to the QF.¹⁶⁵

Since establishing the framework for the taxation of interconnections, the IRS has refined the reach of the "safe harbor" of IRS Notice 88-129 but has not changed the criteria for a nontaxable transfer. In IRS Notice 90-60, the Service recognized that interconnections could be used by both the utility and the QF, with the utility paying fair market value for that use.¹⁶⁶ In that case, the utility is credited with extension allowances or similar payments in the taxable transfer that is deemed to take place at the end of the power purchase contract. The Service departed from the "willing buyer, willing seller" mode of determining fair market value and accepted the determination of the regulating utility commission that a payment by a utility at the end of a power purchase contract would be fair market value.¹⁶⁷ Finally, the fair market value of the interconnection at the end of a power purchase contract is determined by whether or not, and how, the utility intends to use the interconnection.¹⁶⁸ A utility that does not use the interconnection after the contract is taxable on the salvage value of the intertie.¹⁶⁹

Changes to the electric power industry and its participants, as described above in Part I, left large gaps in the coverage of IRS Notice 88-129. In IRS Notice 2001-82, the Service extended the availability of the safe harbor of IRS Notice 88-129 to transfers of interconnections to utilities from non-qualifying facilities, *i.e.*, stand-alone generators, such as independent power producers and exempt wholesale generators.¹⁷⁰ IRS Notice 2001-82 also addresses cases involving interties that are used wholly or partially to wheel power to customers of the stand-alone generator. In those situations, the parties can transfer an intertie in connection with a long-term interconnection agreement between the utility and the stand-alone generator, the term of which is not less than ten years, and pursuant to which the ownership of the power that is wheeled by the utility passes to the purchaser prior to its transmission on the utility's grid.¹⁷¹ The transfer of ownership will be deemed to be before transmission if title to the wheeled electricity passes to the purchaser at the busbar on the generator's end of the intertie. In addition, the safe harbor of IRS Notice 88-129 now covers dual-use interties by which the generator can buy power from a third party. Finally, IRS Notice 2001-82 requires the power generator to amortize the cost of

165. *Id.*

166. I.R.S. Notice 90-60, 1990-2 C.B. 345.

167. *Id.*

168. I.R.S. Notice 90-60, 1990-2 C.B. 345.

169. *Id.*

170. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619. "For transfers of interties occurring on or before the December 24, 2001 effective date and meeting the requirements of this notice, taxpayers may request application of this notice through a request for a private letter ruling (including . . . circumstances where the taxpayer's return for the year of transfer has already been filed." *Id.*

171. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619.

the interconnection as an intangible asset over twenty years on a straight-line basis.

IV. BEYOND IRS NOTICE 2001-82

To ascertain the tax burden of any interconnection payment, members of the electric industry have relied on the IRS notices¹⁷² and have asked the IRS for guidance through private letter rulings.¹⁷³ Safe harbors and private letter rulings are time-consuming and lengthy procedures. Moreover, any safe harbor that the IRS tries to craft for the taxation of interconnections will inevitably leave gaps. This is understandable because any safe harbor has to define a situation in which the IRS is comfortable with the tax results, so the safe harbor will necessarily represent a fixed, and often conservative factual setting. What is needed is a more generic analytical framework for testing different situations as they arise.

The underlying tax policy question of whether a transfer is an advance payment for the performance of services is, in a sense, the second phase of the analysis that must be applied to the modern electric power industry. The proper first phase should be an analysis of whether, or when, a transfer has occurred. The tax law no longer looks to the transfer of bare legal title as determinative. Rather, an inquiry into which party enjoys the economic benefits and bears the economic burdens of ownership should be made to determine whether the power generator has, in a tax sense, transferred property to the utility in the first place. If a power generator retains tax ownership of the facility under a benefits-and-burdens analysis, it has not transferred property to the utility. An inquiry as to whether the utility has received a nonshareholder contribution to capital or a payment for services would be premature. On the other hand, if the utility bears the economic burdens and enjoys the economic benefits of the facility, a transfer has been made. It must then be determined whether the transfer of property was in payment for services, income of a more general character, a contribution to capital, or a transfer of some other nature, such as a loan.

The benefits-and-burdens analysis must necessarily take note of the treatment of interconnections by the FERC and the parties involved. Although nontax regulatory schemes are not generally determinative of tax consequences, the practical consequences of regulatory action influence, or dictate in some instances, who bears the economic burdens and enjoys the economic benefits of ownership. Certainly the IRS has taken note of regulatory aspects of the interconnection issue from the inception. IRS Notice 88-129 requires that for tax-free treatment the interconnection cannot be included in a utility's rate base. IRS Notice 90-60 accepts regulatory findings of fair market value in certain circumstances. Analyzing regulatory consequences in the context of determining the economic burdens and benefits of ownership makes sense. It will provide flexibility, without undermining the tax policy behind taxing payments for

172. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619; I.R.S. Notice 90-60, 1990-2 C.B. 345; I.R.S. Notice 88-129, 1988-2, C.B. 541; I.R.S. Notice 87-82, 1987-2 C.B. 389.

173. In recent years the Service has issued private letter rulings regarding contributions to electric utilities. Priv. Ltr. Rul. 200224023 (Mar. 14, 2002); Priv. Ltr. Rul. 200134021 (May 30, 2001); Priv. Ltr. Rul. 200133036 (May 22, 2001); Priv. Ltr. Rul. 199920027 (Feb. 18, 1999).

services and determining the tax character of a transfer of property.

The requirements in IRS Notices 88-129, 90-60, and 2001-82 appear to cover several bases at once without differentiation: customer status of the power generator (relevant to a taxable contribution in aid of construction), tax ownership of the facility (relevant to whether or not a transfer has taken place), and administrative ease. Analytically, however, there are discrete steps with a definite ordering. Once it is determined which party has the economic benefits and burdens of ownership, it can be determined whether or not there has been a transfer of property for tax purposes. Any transfer has to be subjected to a further analysis of whether it represents a payment for services by a customer or a potential customer. If it does not, the payment has to be tested to see whether it is income, a contribution to capital, or a loan. Each of these steps involves different considerations. Further, they may not all have to be examined at the same time.

A. *Interconnection Facilities and System Upgrades*

All of the IRS notices deal with interties, which include, in the FERC's terminology, interconnection facilities and network facilities. The difference in regulatory treatment helps indicate whether or not a transfer has taken place for the first step of the tax analysis.

1. Interconnection or Direct Assignment Facilities

A generator may build an interconnection facility and transfer it to the utility or, as explained above, a utility may charge a generator directly for the full costs associated with direct assignment facilities in cases in which the utility builds the facility. In either event, the generator shoulders the cost of construction. The utility can also charge the generator for maintenance. In addition, direct assignment facilities are not included in the utility's rate base. The utility does not bear the economic burdens of ownership, since the generator pays for construction and maintenance, does not enjoy the economic benefits, and cannot receive a return on the investment through its rate structure. Under these circumstances the generator should continue to have tax ownership of the facility since no transfer has occurred for tax purposes, and the generator should be able to depreciate the cost of the facility. The utility has not received tax ownership and does not have a realization event at the outset of the interconnection.

The fact that IRS Notice 2001-82 requires, in addition, a long term power purchase or interconnection agreement and the passage of power ownership to the customer before the power is transmitted on the grid should not be relevant to the issue of who owns the property for tax purposes. If the generator is considered to enjoy the benefits and bear the burdens of the interconnection economically, it should not matter how long the interconnection or power purchase agreement is initially, whether the agreement is renegotiated within ten years, or where the title to electricity passes, as long as the generator uses the interconnection to supply power into the grid.

In the case of a dual-use intertie, some *de minimis* test (such as the 5% test)

would still be necessary to determine to what extent, if any, the generator is a customer of the utility. Where the utility uses the interconnection in its business of providing power to the generator to the extent that the generator is considered to be a customer of the utility, the use of a portion of the interconnection by the utility is a taxable in-kind payment by the generator for services.

At the point in time that an event occurs that may transfer tax ownership of the facility, such as at the termination of a power purchase agreement that is not renewed, the benefits-and-burdens test must be employed again. If a transfer occurs, the nature of the transfer must be determined. If the utility does not pay fair market value for the interconnection facility, it becomes relevant at that time as to whether the generator continues to be a customer or a potential customer, which is paying for services. If the generator is not a customer and the payment is not for services, the generator may still lack the public purpose required for a contribution to capital, since its direct assignment facility may not be considered part of the grid for regulatory purposes and would not benefit other grid users. In that case, the transfer would be a taxable transaction outside the scope of section 118. Without a qualifying motive on the part of the generator, the other four parts of the *Chicago, Burlington* test would be irrelevant.¹⁷⁴

2. System Upgrades

The "or pricing" used for system upgrades produces a substantially different result. Under "or pricing," a utility can recover its costs, either from ratepayers in general or from the generator under incremental pricing, and can earn a return on the invested capital, either through rolled-in transmission rates or from revenue requirements used to compute incremental pricing. Clearly the utility enjoys the economic benefits and bears the economic burdens of the system upgrade to the same extent that it does so with respect to other utility property subject to rate regulation.

Under a benefits-and-burdens analysis, the utility owns the system upgrades. The rates that it charges for transmission, which include components for the upgrades, are income to it. Recently, the FERC has allowed the utility to charge generators an up-front fee in an amount equal to the cost of the upgrade for which the utility must grant the generator transmission credits, which must include an interest component.¹⁷⁵ The second part of the analysis must determine the nature of the up-front cash transfer from the generator to the utility. For tax purposes, this arrangement could be structured as a contingent payment debt instrument. Factors such as a maturity date by which time unused

174. Requiring representations under *Chicago, Burlington* by the utility at the outset of the transaction is contradictory. If the interconnection is used by a generator to supply its power into the grid, the utility would be hard pressed to make the representation that the use of the interconnection in its own business is commensurate with the value of the interconnection. Priv. Ltr. Rul. 200134021 (May 30, 2001) (representations that the interconnection facilities will not be included in the utility's rate base, the utility will not earn a return on the cost of constructing the interconnection facilities, and the interconnection facilities will be used by the utility in its trade or business to produce income). The last representation is more appropriately made when the utility is considered to own the interconnection.

175. See generally *Entergy Gulf States, Inc.*, 98 F.E.R.C. ¶ 61,014, *reh'g denied*, 99 F.E.R.C. ¶ 61,095 (Jan. 11, 2002); *Southern Co. Serv., Inc.*, 94 F.E.R.C. ¶ 61,131 (2001).

credits would be paid in cash, an explicit provision for interest on unpaid principal, creditor's rights on default, and a formal instrument setting forth the rights of the parties would all be helpful from a tax perspective in characterizing the payment by the generator as a loan to the utility.¹⁷⁶

If the arrangement is not a loan for tax purposes, the age-old question of whether or not the generator made a nonshareholder contribution to capital as a customer or potential customer—*i.e.*, whether or not the contribution was in payment for services rendered or to be rendered—would ensue. IRS Notice 2001-82 requires ownership of the electricity produced by the generator to pass to the customer before the power is transmitted on the grid. This part of the safe harbor ensures that the generator will not be a transmission customer of the utility. If this condition is met, a generator should be able to take the position that it should not be considered a transmission customer even if other elements of the safe harbor are absent.

If the generator is not a customer of the utility, the integration of the system upgrade into the grid, which benefits all power consumers and is often overscaled to accommodate future power suppliers, would appear to be the sort of public benefit envisioned by *Edwards*.¹⁷⁷ Moreover, it should be relatively easy for the utility to represent that the property meets the four other parts of the *Chicago, Burlington* test to qualify as a contribution to capital. As a result, the payment should be a nontaxable, nonshareholder contribution to capital if it is not a loan.

B. Transmission Companies that are Partnerships

Neither IRS Notice 2001-82 nor its predecessors give any guidance with respect to transmission companies that are treated as partnerships for tax purposes.¹⁷⁸ The entity characterization of the transmission company as a corporation or a partnership for tax purposes, however, is relevant only in limited circumstances. It has no bearing on the benefits-and-burdens determination, which is an entity neutral analysis. Similarly, whether transmission credits represent a loan depends upon the characteristics of the credits, not on whether the debtor is a partnership or corporation. Only if the benefits-and-burdens analysis indicates that the generator transferred property to the transmission company for tax purposes in a transaction that was not a sale

176. In *Union Pac. R.R. Co. v. Comm'r*, 26 B.T.A. 1126 (1932), the court addressed several of these factors in determining whether amounts unrefunded under a contract constituted contributions to capital or guaranties to ensure performance of contracts. The deposits were to be refunded at a specified rate per carload shipped by the industry over the facilities within a designated period of time. The court noted that the contracts did not create obligations to ship freight over the facilities, and that "the contracts merely provide that if and when shipments are made by the depositor the amounts deposited will be refunded on a carload basis." *Id.* at 1128. The court concluded that the amounts were contributions to capital and consequently not taxable. *Union Pac.*, 26 B.T.A. at 1128. Because the customer did not have the obligation to use the facilities, the railroad had no obligation to repay. At the least, there must be an obligation on the part of the utility to refund the amount advanced by the generator in order for the transfer to be treated as a loan. *Id.* at 1133.

177. *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 633 (1925).

178. In addition to general and limited state law partnerships, joint ventures and limited liability companies can elect to be treated as partnerships.

and not a loan will the latter's entity classification have any consequence. Consequently, payments by a generator for direct assignment facilities should not generate tax to a transmission provider that is taxed as a partnership during the term of a power purchase or interconnection agreement under the analysis discussed above.

Assuming that at some point a transfer of property to the transmission company takes place and the conditions for a nonshareholder contribution to capital would be met if the transmission company were a corporation, the question is whether a nonpartner contribution to capital may be tax-free to a partnership under current law. The Internal Revenue Code states that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ."¹⁷⁹ The modern definition of "income" in the Code was developed by the Supreme Court in 1955 in *Glenshaw Glass*, in which the Court interpreted income to mean "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."¹⁸⁰ Courts have viewed the broad sweep of the definition of "income" after *Glenshaw Glass* as eroding the case law that led to the enactment of section 118.¹⁸¹ In a judicial forum, therefore, a court would be likely to invoke the tax principle that exclusions from income are matters of legislative grace and are to be narrowly construed.¹⁸² In the case of corporations, section 118 excludes from gross income contributions to capital that are not made by a customer or potential customer. In the case of partnerships, there is no statutory analogue to section 118, which deals exclusively with corporations. Therefore, partnerships would be taxable because there is no statutory exception from income in the Code for nonowner contributions to capital.¹⁸³

179. I.R.C. § 61(a) (2002).

180. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). This definition greatly expanded the definition of income laid down in the earlier case of *Eisner v. Macomber*, which referred to income as profits or gain derived from labor, or from capital, or from both. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

181. *Hayutin v. Comm'r*, 508 F.2d 462, 479 (10th Cir. 1974); *State Farm Rd. Corp. v. Comm'r*, 65 T.C. 217, 227 (1975).

182. In developing the "accession to wealth" definition of income, the Court in *Glenshaw Glass* distinguished its approach from the more limited definition in *Eisner*. *Glenshaw Glass*, 348 U.S. at 430. In *Glenshaw Glass*, the taxpayer excluded from its income punitive damages that it had received. The taxpayer and the government agreed that the punitive damages would be income within the meaning of the Sixteenth Amendment, so the issue before the Court was whether the definition of income in the Internal Revenue Code was broad enough to encompass that form of income. *Id.* at 429. The taxpayer argued that the damages were not income under the definition used in *Eisner*. The Court distinguished the *Eisner* definition from the "accession to wealth" approach by saying that the definition in *Eisner* was dealing with the difference between income and capital, which was not the issue before it in *Glenshaw Glass*. Although section 118 deals precisely with the difference between income and capital, subsequent courts have used the *Glenshaw Glass* definition in section 118 analyses. *See generally* *United Grocers, Ltd. v. United States*, 308 F.2d 634, 637 (9th Cir. 1962); *John B. White, Inc. v. Comm'r*, 55 T.C. 729, 734 (1971).

183. The technical issues of whether a nonshareholder contribution to capital can be made to a partnership are outside the scope of this paper. A contribution of capital to a partnership where the transferor does not have the intent to form a partnership and will not receive the contribution back on the liquidation of the partnership should not be treated as a capital interest in the partnership by a partner. *Comm'r v. Culbertson*, 337 U.S. 733 (1949); *Treas. Reg. § 1.704-1(e)(1)(v)* (1956). A partnership is

From a tax standpoint, favoring one form of entity over another in this situation makes no sense because the genesis of section 118 was, at bottom, entity neutral. The legislative history to section 118 speaks of that section as codifying the case law.¹⁸⁴ The reasoning of the relevant Supreme Court cases did not depend upon the corporate nature of the transferee. In dealing with the motive of the transferor, the Court in *Edwards* could have been addressing a transfer of property to a partnership. In *Chicago, Burlington*, the Court enumerated five factors for contributions to capital, none of which hinged upon the corporate identity of the transferee, and all of which looked either to the economic arrangement between the transferor and the transferee or the use of the payment in the capital structure of the transferee.¹⁸⁵ Because these factors are based upon a third party's interaction with the recipient entity, and not upon the relationship between the entity and its owners, the same factors that justified the enactment of section 118 for corporations could be used to justify a legislative change for partnerships.

But such a legislative change is not needed to extend the current safe harbor taxation regime of the IRS notices to partnerships. In the various IRS notices dealing with interties, the IRS treats a disqualification event, such as the termination of the power purchase or interconnection agreement, as a taxable contribution in aid of construction. This merely makes the exclusion from income for nonshareholder contributions to capital unavailable within the safe harbor. In the partnership context, the deemed treatment would be an income inclusion. If a benefits-and-burdens analysis, which is entity neutral, is used as the underpinning for the safe harbor requirements during the term of the relevant agreement, the IRS notices could be applied to partnerships.

V. CONCLUSION

Who bears the tax burden on the transfer of interconnections is an energy regulatory matter because it influences the cost of power and the cost of entry into the power generation industry. The regulatory policy governing interconnections must therefore deal with the allocation of the tax burden. Tax indemnification agreements are being used to allocate the tax burden, and the

variously treated as an entity or as an aggregate of its partners throughout the partnership provisions of the Code. In section 721, neither a partnership nor its partners recognizes income or loss when property is contributed to a partnership in exchange for an interest in the partnership. I.R.C. § 721 (2002). This is one basis for treating a partnership as an entity for purposes of accepting a nonowner contribution to capital. The tax accounting for a nonowner contribution to capital also presents issues. The sum of the partners' capital accounts should match the total partnership capital. If the contribution were booked at its fair market value on contribution, it would have to be allocated to the partners. The closest analogy would be to treat the contribution as tax-exempt income, which would increase the outside basis in the partners' partnership interests. In addition, the basis of the contributed property would be the partnership's cost of zero, since a carryover basis applies only to a partner's contribution of property. I.R.C. §§ 722, 1012 (2002). Booking the contribution at fair market value for section 704(b) book purposes but with a zero tax basis creates the type of built-in gain that is usually allocated to the contributing partner. I.R.C. § 704(c) (2002). The better treatment would be to use a zero fair market value on contribution for section 704(b) book purposes.

184. H.R. REP. NO. 83-1337, at 17 (1954); S. REP. NO. 83-1622, at 18 (1954).

185. *United States v. Chicago, Burlington, & Quincy R.R. Co.*, 412 U.S. 401, 413-415 (1973).

standardization of those agreements is now before the FERC in its Interconnection Rulemaking.

But the tax actually imposed on the transfer of interconnections is a tax policy matter. In the quest for industry certainty, the current IRS notices set forth safe harbors of particular structures for transactions, but these are rigid requirements that may not easily translate into new arrangements as the power industry continues to deregulate. In order to provide increased flexibility to the power industry, business transactions should be analyzed for tax consequences separate and apart from the safe harbors, using the same tax principles as in other areas.