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MEMORANDUM

Date: October 16, 2009

To: VEPGA Board of Directors

From: Louis R. Monacell and Cliona Mary Robb

Subject: Tax Effect Recovery Factor [TERF] Tax on Relocation of Electrical Duct Bank

QUESTION PRESENTED

Do the *Terms and Conditions for the Provision of Electric Service to Municipalities and Counties—Virginia, Effective July 1, 2007 through December 21, 2010,* require the County of Arlington ("County") to pay a tax effect recovery factor ("TERF") tax on payments to Dominion Virginia Power ("Virginia Power") for the relocation of an electrical duct bank where the relocation was necessary to expand the sanitary sewer trunk line?

SHORT ANSWER

The VEPGA contract likely does not require the application of TERF under these circumstances.

Section III.H.2.c of the Terms and Conditions explicitly exempts "relocation projects necessitated by the addition of sidewalks or storm drainage" from TERF payments "in the event and to the extent that contributions in aid of construction for such services, relocations, and conversions are not taxable." If Dominion Virginia Power ("Virginia Power") argues that relocation for a sanitary sewer trunk does not fall within this specific exemption, there is still a valid argument that TERF should not apply because Section III.H. of the Terms and Conditions states that TERF applies "[f]or payments to the Company *which are classified as a contribution in aid of construction*." Payments made for relocation based on expanding a sanitary sewer trunk line should not be classified as "contributions in aid of construction" but should instead be classified as "contributions to capital" because the payments (a) were not made to Virginia Power to provide or to encourage new service, (b) were for the "public benefit," and (c) satisfy the five characteristics of a non-shareholder contribution to capital. Consequently, they should not be considered contributions in aid of construction but instead should be considered contributions to capital and thus would be properly excluded from income under Internal Revenue Code section 118(a). County, therefore, should not pay a TERF tax.

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DISCUSSION

I. Background

The Arlington County Sanitary Sewer Master Plan identified the need for a new sanitary sewer trunk line to serve the high density Rosslyn area. The proposed line would relieve some low-lying areas and homes from wastewater backups which they have experienced during wet weather due to the inadequate capacity of the existing line. The proposed line will approximately double the capacity of the existing line – providing relief for these homes and also providing capacity for continued growth in Rosslyn.

The proposed project involves a 48" sanitary sewer traveling almost two miles from Rosslyn through National Park Service lands and Arlington Cemetery, and terminating at Columbia Pike. A small segment (approximately 300 feet) of the sewer was constructed in conjunction with a highway replacement project about two years ago.

The remainder of the sewer is scheduled to begin construction on October 15, 2009 and will take two years to complete. During the earlier construction, an electrical duct bank was encountered that had not been shown on the plans. After many months, it was ultimately determined to be a live electrical duct owned by Virginia Power. That duct bank is in direct conflict with the proposed sanitary sewer line. Due to the size of the proposed sewer and the very small tolerance for vertical adjustments of the sewer, the only available solution is to relocate the Virginia Power duct bank. The County has developed a solution which Virginia Power has accepted for the relocation of the duct bank to allow for the construction of the sanitary sewer.

II. Analysis[1]

Under Section 61 of the Internal Revenue Code, "gross income" includes "all income from whatever source derived" unless it is specifically excluded from gross income by another section or provision of the Internal Revenue Code. Section 118(a) provides that, in the case of a corporation, gross income does not include any "contribution to the capital" of the taxpayer. Gross income, however, does include a contribution in aid of construction. I.R.C. §118(b). Since taxable income is defined by Section 63 as gross income less any available deduction, the Section 118(a) exclusion from gross income would make "contributions to capital" non-taxable. The ability to classify an item as a contribution to capital, thus, has significant impact on the taxpayer.

Contribution to capital is not defined in the Internal Revenue Code, but legislative history indicates that § 118 was intended to be a codification of existing law. (H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954) as cited in GLAM 2007-003, p.4) An examination of the case law provides some insight into the

[1] This memorandum and the analysis it contains borrows heavily from the discussion presented by the Office of the City Attorney of the City of San Diego in its April 2, 2004 Memorandum of Law to Larry Gardner, Director, Water Department on a similar issue.

definition of contribution to capital, though, as stated in *State Farm Road Corporation v. Commissioner,* 65 T.C. 217, 226 (1975), "the climate created by the judicial history dealing with contributions to capital is, to say the least, strange."

The foundation of the exclusion to gross income found in Section 118(a) is *Edwards v. Cuba R.R. Co.,* 268 U.S. 628 (1925). In *Edwards,* the, Supreme Court held that government subsidies to a railroad to induce the construction of railroad facilities were contributions to capital and not taxable income. The Court reached this conclusion because the payments "were not made for services rendered or to be rendered" and were not "profits or gains from the use or operation of the railroad." *Id.* at 633. Though the payments were not gifts, they were not made to obtain concessions or to obtain reduced rates for the government: the government's purpose was to obtain a benefit for the public. *Id.* at 632. *Detroit Edison Co v. Commissioner of Internal Revenue,* 319 U.S. 98 (1943) further developed what constituted a payment for service.

This public benefit exception was revisited in *Brown Shoe Co., Inc. v. Commissioner of Internal Revenue,* 339 U.S. 583 (1950). In *Brown Shoe Co.,* community groups gave taxpayer more than $900,000 to build or expand manufacturing facilities. In holding that the payments by the community groups were contributions to capital, the Court stated that the payments were not the price of service. *Id.* at 591. "[S]uch contributions might prove advantageous to the community at large." *Id.* As such, they were excluded from gross income. *Id.*

These cases establish two requirements for the public benefit exception: 1) the money or property may not be a payment for service; and 2) the payment must have the purpose of providing a public benefit. A payment which is not a payment for service and has the purpose of providing a public benefit will be considered a non-shareholder contribution to capital and can be excluded from taxable income under Section 118(a) of the Internal Revenue Code.

The United States Supreme Court revisited this issue in *U.S. v. Chicago, Burlington & Quincy Railroad Co*., 412 U.S. 401, 93 S. Ct. 2169 (1973). In this case, the Court said "It seems fair to say that neither in *Detroit Edison* nor in *Brown Shoe* did the court focus upon the use to which the assets transferred were applied, or upon the economic and business consequences for the transferee corporation. Instead, the Court stressed the intent or motive of the transferor and determined the tax character of the transaction by that intent or motive. Thus, the decisional distinction between *Detroit Edison* and *Brown Shoe* rested upon the nature of the benefit to the transferor, rather than to the transferee, and upon whether that benefit was direct or indirect, specific or general, certain or speculative. These factors, of course, are simply indicia of the transferor's intent or motive." From these two cases, the court distilled five characteristics of a non-shareholder contribution to capital which must be applied to any § 118(a) analysis. The remainder of this memorandum describes the case law and IRS guidance that establishes what is considered a payment for service, what constitutes a public benefit, and the five characteristics of a non-shareholder contribution to capital which must be applied to any § 118(a) analysis.

A. Payment for Service

Congress defined a "payment for service" as a transfer of "any property, including money [taxpayer] receives to provide, or encourage... the provision of services" of the kind the utility provides. H.R. Rep. No. 99-426, at 644. A utility is considered as having received property to encourage the provision of services if any of the following conditions are met: 1) the receipt of

the property is a prerequisite to the provision of services; 2) the receipt of property causes services to be provided earlier than had property not been exchanged; or 3) the receipt of property causes the transferor to be favored. *Id.* A customer connection fee which includes charges for construction of facilities is a payment for services. Rev. Rul. 75-557, 1975 2 C.B. 33. Charges to tie in to a sewer system are payments for service. *State Farm Road Corporation,* 65 T.C. at 226. Reimbursements for the construction of either electric or sewer lines intended to service a development are payments for service. *Detroit Edison,* 319 U.S. 98 (1943); *EPCO, Inc. v. Commissioner of Internal Revenue,* 104 F.3d 170 (1997). Even the cost of construction of a television antenna borne by the prospective customers of the television service is a payment for service. *Teleservice Company of Wyoming Valley v. Commissioner of Internal Revenue,* 254 F.2d 105 (1958).

In *Detroit Edison Co.,* 319 U.S. at 99-100, prospective customers of Detroit Edison, an electric utility company, applied to obtain service. Detroit Edison required the applicants to pay approximately $1,160,000 to build the facilities needed to provide the electric service. The utility treated this payment as a contribution to capital. The court held that the payments were the price of service, not contributions to capital. *Id.* at 103. The individuals contributing these funds were required to pay to obtain the service. *Id.* at 99.

In *Teleservice Company of Wyoming Valley,* 254 F.2d at 106-107, payments by a community group to build a television antenna were considered payments to obtain service. Without the antenna, none of the residents could obtain a television signal. Yet, with the antenna, only those individuals who paid the "contribution" would obtain television service. The court reasoned that these payments were in essence fees for television service. *Id.* at 111. The payments were a "prerequisite to obtaining direct personal service via the construction of the facilities which would provide such service." *Id.*

B. Public Benefit

A payment must also provide a "public benefit" to qualify for the exception. *See Edwards,* 268 U.S. at 632; *Brown Shoe Co.,* 339 U.S. at 591. A public benefit is one for the community at large. *Brown Shoe Co.* at 591. It may promote settlement, provide for development, or enhance community esthetics and public safety. *See Edwards,* 268 U.S. at 632; *Brown Shoe Co.,* 339 U.S. at 591. I.R.S. Notice 87-82, 1987-2 C.B. 389. It may not be for a particular tract of land on which a developer is establishing a community, nor for an individual or group making the payment. *See Detroit Edison Co.,* 319 U.S. at 102; *Teleservice Co. of Wyoming Valley,* 254 F.2d at 111-112; *EPCO, Inc.,* 104 F. 3d at 172-173; *Florida Progress Corporation v. United States of America,* 156 F.Supp.2d 1265 (M.D. Fla. 1999).

An Internal Revenue Bulletin and two subsequent Letter Rulings apply and reaffirm the public benefit exception established in *Edwards.* In I.R.S. Notice 87-82, 1987-2 C.B. 389, the Internal Revenue Service [IRS] addresses "numerous inquiries" received regarding the tax treatment of payments for the relocation of utility facilities. Several examples were addressed and classified as either taxable or nontaxable. A payment to a utility for a government "undergrounding" program, which is undertaken for the purpose of community esthetics and public safety, is not taxable. Similarly, a payment to a utility to relocate utility lines in order to

accommodate the construction or expansion of a highway is not taxable. Such payments do not reasonably relate to the provision of services by the utility. *Id.* The payments relate to the "benefit of the public at large." *Id.*

In Private Letter Ruling 01-33-036 (May 22, 2001), the IRS examined the case of a power company relocating power lines to facilitate construction of additional lanes of traffic. The payments were not a prerequisite to obtaining utility service, because the service already existed, and the relocation of the lines provided for a public benefit: the additional traffic lanes would promote public safety. The IRS ruled that "the payment received by Taxpayer for the relocation of power lines is not a CIAC under Section 118(b) and qualifies as a non-shareholder contribution to the capital of the taxpayer under Section 118(a)."

Private Letter Ruling 01-33-037 (May 22, 2001) deals with a similar application of the public benefit exception. A city intends to build a bus terminal which will connect numerous routes, provide a location for bus to bus transfers, reduce cross town travel time by approximately fifteen minutes, and allow for a reduction of 96,000 bus miles per year. In order to build the facility, the city must relocate a gas line to a location off the project site for the purpose of public safety. The city will pay the utility to relocate the gas line. The IRS concluded that the payment to relocate the gas line falls within the public benefit exception, and the payment could be treated as a contribution to capital.

C. Five Characteristics of a Non-shareholder Contribution to Capital

In a recent IRS Generic Legal Advice Memoranda (GLAM 2007-003), the IRS applied the payment for service and public benefit tests to a §118(a) question but it also applied five characteristics of a non-shareholder contribution to capital listed in *U.S. v. Chicago, Burlington & Quincy Railroad Co.,* 412 U.S. 401, 93 S. Ct. 2169 (1973). These five characteristics are: (1) it must become a permanent part of the transferee's working capital structure; (2) it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) it must be bargained for; (4) the asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. The Court in the CB&Q decision concluded that the recipient corporation failed to satisfy three of these five criteria, therefore, the payment was denied capital contribution status. As to the three criteria not satisfied, the Court found that the assets were not in any real sense bargained for by the railroad, were constructed through the subsidies primarily for the benefit and safety of the public with regard to highway traffic, were peripheral to the railroad's business, and did not materially contribute to the production of further income. *Id.* at 413-14. This resulted even though the payor's motivation may well have supported a finding of capital contribution status.

Analysis in *Tax Management Portfolio* also supports the proposition that to qualify as a non contribution to capital excludable under § 188, a contribution must satisfy the five factors established in the CB&Q decision. Contributions that have been found to satisfy these factors

include a city's payment to a corporation to bury overhead electrical lines[2] and also include a foundation's payment to a utility on behalf of a school district for relocation of gas transmission lines.[3] Contributions that have been found not to satisfy the five factors include payments from state underground storage tank cleanup reimbursement programs which are received by the operators of such storage tanks.[4]

D. Overall Assessment of Whether a Contribution is a Contribution in Aid of Construction

There is precedent for determining that payments being made for a public benefit—rather than in an entity's capacity as a customer—would not be treated as taxable contributions in aid of construction as long as the conditions discussed above are met. However, a publication interpreting tax regulations has determined that the "actual determination of whether a contribution is in aid of construction can be problematic." To give VEPGA members a sense of how the IRS has addressed particular situations governing this issue, the following passage from *Tax Management Portfolio,*[5] is quoted at length in the italicized text below, with footnotes included:

> *The treatment of payments to utilities for modification or relocation of facilities illustrates the uncertainties that challenge transactional planners. Transactions treated by the IRS as within the scope of the § 118 exclusion include payments and property received by an investor-owned utility for funding of overhead power line relocation to underground conduits,[6] a county's contribution to a public utility for movement of power lines to facilitate the county's landfill expansion,[7] a county's contribution to a utility to improve airport safety by relocating its transmission lines to underground conduits,[8] a foundation's contribution to a utility on behalf of a school district to improve public safety by relocating gas transmission lines,[9] a city's payment to a utility to relocate gas pipelines in order to develop a site for a housing project,[10] municipality payments to a utility for replacing street lighting,[11] and payments to a utility for temporary relocation of overhead power lines and for relocation of power lines from overhead locations to underground conduits.[12] Yet the IRS has also ruled that a government's transfer of gas lines to a utility as an inducement for the utility's furnishing of gas to a public housing project and a governmental authority's payment to a utility*

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[2] PLR 200820033, *as cited in* Maule, 501-3rd Tax Management Portfolios, *Gross Income: Overview and Conceptual Aspects ("*501-3rd TM"), section IX.B.5.b(2)(a) at A-117.
[3] PLR 2000448026, *as cited in* 501-3rd TM, section IX.B.5.b(2)(a) at A-117.
[4] Large and Midsize Business Division abuse directive, LMSB-4-11108-054 (February 5, 2009), *as cited in* 501-3rd TM, section IX.B.5.b(2)(a) at A-117.
[5] 501-3rd TM, section IX.B.5.b(3) at A-119 to A-120.
[6] Private Letter Ruling (PLR) 9249020. *See also* PLR 200820033 (city's payment to corporation to bury overhead electrical lines within scope of § 118).
[7] PLR 9448005.
[8] PLR 9448006.
[9] PLR 200048026.
[10] PLR 200647002.
[11] PLR 9538037, PLR 9427008.
[12] PLR 9306009.

for the installation of new circuit breakers to provide more reliable service for customers in an urban renewal area were contributions in aid of construction not eligible for the exclusion.[13] *In addition, payments by a developer to an electric utility for relocation and reconnection of utility poles and lines and payments made by a developer to a public utility to "underground" perimeter lines and to connect the newly undergrounded lines to the existing underground line constitute contributions in aid of construction.*[14] *The IRS also concluded that a public utility must include in gross income any excess distribution facility charges and separately calculated underground service charges received from a state agency for the installation and modification of utility facilities supplying power to traffic signals and street lights,*[15] *and that a utility must include in gross income payments received from a tax-exempt university for relocating electric transmission lines on the university's campus.*[16]

Observation*: The stated rationale in the first favorable ruling involved the character of the relocation project as a "government program."*[17] *In three other rulings, the existence of a public benefit was significant.*[18] *Yet these factors do not adequately explain the adverse rulings nor do they provide a basis for distinction.*

CONCLUSION

Payments to relocate utility facilities in order to expand the sanitary sewer trunk line will likely meet both requirements of the public benefit exception because the payment is not a prerequisite to obtaining electric service, and the payment is intended to provide a public benefit. No additional electric service is obtained because this involves the relocation of an existing duct bank. A public benefit exists because the relocation of the duct bank allows for the expansion of the sanitary sewer line which will provide relief for homes in low-lying areas and provide capacity for continued growth in Rosslyn.

Furthermore, the five characteristics of non-shareholder contribution to capital appear to be satisfied. First, the new electrical duct bank will become part of Virginia Power's permanent structure. Second, the payments were not for electric service provided for the County by Virginia Power. Third, the payment and relocation were bargained for between County and Virginia Power. Fourth, the electrical duct bank will result in a benefit to Virginia Power in an amount commensurate with its value. Fifth, moving the duct bank will allow it to continue to contribute to the production of additional income. As the payments to Virginia Power for the relocation of the utility facilities are not "payment for services," provide a "public benefit," and meet the five CB&Q characteristics of a non-shareholder contribution to capital, they should be considered contributions to capital.

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[13] PLR 200224023, PLR 9344006.
[14] PLRs 200541036, 200542001.
[15] PLR 9501022.
[16] PLR 200450035.
[17] PLR 9249020 (citing Notice 87-82, 1987-2 C.B. 389).
[18] PLR 200820033, PLR 9538037, PLR 9427008.

Thus, based on I.R.C. § 118(a), there is a strong argument to be made that the payment should not be included in gross income, and the County should not pay the TERF on the charges for the relocation work, irregardless of whether the work falls within the specific exemptions from TERF outlined in Section III.H.2.c of the Terms and Conditions of the VEPGA contract.

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