General Counsel Memorandum 38944

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December 13, 1982

Br6:GRCarrington

Date Numbered: December 27, 1982

Memorandum to:

TO: GERALD G. PORTNEY

Associate Chief Counsel (Technical)

Attention: Director, Corporation Tax Division

Director, Individual Tax Division

By memorandum dated ***, the Director, Tax Litigation Division, requested our views in the subject case. We request your concurrence or comments on the position we take herein.

ISSUE

Whether, under I.R.C. s 118 or decisional law, a regulated public utility operating in partnership form may exclude from its gross income "contributions" received by the partnership from the *** so that it could expand its sewer facilities to service a *** housing project.

CONCLUSION

The partnership cannot under I.R.C. s 118 or decisional law exclude from its gross income the "contributions" received from the *** to expand its sewer facilities to service a *** housing project.

FACTS

*** (hereinafter referred to as ***) is a regulated public utility, operating in the form of a partnership, that furnishes water and sewer service in the city of ***. In 1976, the *** contracted with *** to expand its facilities so that the utility would be able to service a 400 unit housing project the *** was planning to construct on property it owned in ***. It was necessary that provision be made for the collection and treatment of the sewage and waste water of the housing project.

Under the contract, the *** agreed to pay $54,800 for the construction of a sewage pumping station and the pipes through which the sewage would be pumped to the utility's existing waste treatment plant. (Such pipes are hereinafter referred to as force mains). The construction was completed in *** and billed to the *** as a "Connection Charge "

A breakdown of the costs charged the *** is as follows:

1. Sewage pumping station

2. Force main-housing area

3. Force main-

4. Force main-

Total

Although the *** only agreed to pay the utility $54,800 for the construction necessary to service the project, the total cost of the construction was ***. *** invested its own funds for costs of construction in excess of ***. The *** agreed to

pay 100% of the cost of the sewage pumping station, 100% of the cost of the on-site force main in the housing area, but only 80% of the *** cost of the on-site force main on *** and 50% of the projected *** cost of the off-site force main on ***. The reason for the allocation was that the company would be able to use sections of the force mains numbered three and four, above, to service future customers other than the projected 400 unit apartment project. Future customers living in the *** and *** areas will be able to connect their homes or businesses to the utility's waste treatment plant for a modest fee since the utility will not have to construct a line from their property to the main sewer treatment plant as the *** here.

Finally, the books and records of *** reflect that the partnership recorded the *** as contributions in aid of construction and recorded no customer connection or tap-in fees. Also, the partnership excluded the *** from its rate base.

ANALYSIS

Section 118 provides:

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

(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 1 which provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewerage disposal services if-

(A) such amount is a contribution in aid of construction, 2 (B) where the contribution is in property which is other than electric energy, gas steam, 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.

The general income exclusion rule of section 118(a) only applies to corporations. Section 118(a) specifically provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Under section 118(b), in order for a contribution in aid of construction to be considered to be a contribution to the capital of a taxpayer, the taxpayer must be a regulated public utility operating in the corporate form. Consequently, because this regulated public utility operates in partnership form, it cannot avail itself of the exclusion provided for by section 118.

Section 118(a) 3 was first enacted in 1954. The legislative history of that section indicates that the general income exclusion rule of section 118(a) was intended to apply to those nonshareholder contributions that are neither gifts, because the contributor expects to derive indirect benefits, nor payments for future services, because the anticipated future benefits are too intangible. H.R. Rep. No. 1337, 83d Congress, 2d Sess. 17 (1954); S. Rep. No. 1622, 83rd Congress, 2d Sess. 18-19 (1954). The provision was a codification of administrative rulings and court decisions. H.R. Rep. No. 1337, 83d Cong., 2nd Sess. 17, A-38 (1954), S. Rep. No. 1622 83d Cong., 2d Sess. 18 (1954). Simultaneously, section 362(c) was enacted to insure that if the recipient corporation did not take the contribution into income it was not to get a basis in the assets acquired with the contribution.

Under case law prior to the enactment of section 118(a) and 362(c), nonshareholder contributions to capital were not taken into income by the recipient corporation under a narrow reading of the gross income provision, 4 but the corporation would have a basis in the asset(s) acquired with the contribution.

5 The result was a double benefit to the corporation. To obviate this, Congress ultimately asserted its authority; it codified the case law on the income side by

enacting section 118 specifically providing for an exclusion from income for certain capital contributions, but reversed that case law on the deduction side by enacting section 362(c) providing for a zero basis for property acquired with those contributions. As pointed out above, both of these statutes, by explicit language, are applicable only to corporations.

Whether this was intentional or merely an oversight is not known. While operating a public utility in other than corporate form may not be the norm, it is not that unusual, particularly for water and sewage companies, that ignorance of that fact should be ascribed to Congress. In any event, since Congress either ignored or chose to exclude business forms other than corporations, there is no warrant to assume for either alternative that the situations can be equalized by applying section 118 and 362(c) to regulated public utilities operating in partnership or any other form. And since all the applicable case law preceding the enactment of those provisions was with respect to corporations and since Congress pre-empted the area with the enactment of sections 118 and 362(c), 6 the rationale of that case law seemingly survives only as an aid in interpreting those sections.

If the case law rationale is considered controlling in situations involving noncorporate entities to which sections 118 and 362(c) do not apply and such noncorporate entities could meet the tests laid down in the case law, then the result would be to reinstate the double tax benefit turmoil that sections 118 and 362(c) were enacted to eliminate. 7 Therefore, while it may seem anomalous to treat the "contributions" differently depending on whether they are made to corporations or partnerships, it is no more anomalous than it would be to apply to a partnership, the rationale of the old case law when that rationale would result in a double tax benefit to the partnership that is denied to the corporations by statute. Accordingly, since there is no statute under which "contributions" by a third party to an unincorporated taxpayer can be excluded, such amounts are, in our view, includable as section 61 income within the meaning of Commissioner v.

Glenshaw Glass Co., 348 U.S. 426 (1955) and General American Investors Co. v. Commissioner,348 U.S. 434 (1955).

While the above analysis would seem to be dispositive, an alternative argument along the lines made in ***, G.C.M. 37354, I-155-77 (Dec. 21, 1977) [hereinafter ***], would likewise seem to result in treating the amounts involved here as section 61 income. Unlike the instant taxpayer, *** was and is a corporation that engages in the sale of electric energy. Like the taxpayer here, it is a regulated public utility that received payments in aid of construction. We concluded, after analyzing the applicable case law, that the payments were not contributions to the corporation's capital within the meaning of section 118(a). 8

In order for a nonshareholder transfer of cash or property to a corporation to qualify as a contribution to capital, the transferor must have the requisite motivation and the transfer must have the necessary economic effect on the corporation as described by the Supreme Court in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973). We stated in G.C.M. 37354 at 25:

[I]f money and/or property is transferred to a corporation by an entity, be it individual, association of individuals, or government unit, as: (1) a payment for services rendered; or (2) a prerequisite for doing business with the recipient corporation; or (3) a payment to achieve a business purpose of the transfer and there is a reasonable nexus between such payment and the services which it is the business of the recipient corporation to provide or between such payment and the transferors' business, the transfer is not a contribution to capital because of the lack of the requisite motivation on the part of the transferor.

We stated further that if the transferor had the prohibited motivation, then it was unnecessary to analyze a transaction from the recipient corporation's viewpoint to determine whether the transfer had the necessary economic effect.

*** received contributions in aid of construction from a quasi-government entity. The entity, ***, was created pursuant to *** with the primary function to plan, develop, finance, and operate a rapid transit rail system serving the ***. The *** "contributions in aid of construction" were for the cost of constructing and installing additional distribution facilities by *** to enable it to furnish *** with the necessary power to operate the rapid transit system.

We based our decision on the fact that *** did not have the significant motivation for two reasons. First, since *** had to enlarge its facilities to supply *** with the power needed to operate its rapid transit rail system, we decided the *** "contributions" were made because of the desire to obtain the needed power.

Because the benefit received by *** as a result of its "contributions" to *** in the form of the right to obtain electric power was a direct benefit, we decided further that the "contributions" made by *** represented the cost of obtaining direct electrical services. G.C.M. 37354 at 27. We noted, however, that the "contributions" made by *** to *** were not present payments for future services. Instead, they were present payments for the right to receive services in the future. The "contributions in aid of construction" did not entitle the transferor to any quantifiable amount of future services, but they did entitle the transferor to the right to obtain services in the future upon payment of periodic charges applicable to electrical services rendered. Accordingly, under the case law, the "contributions" were payment for services.

Second, we decided that under the business purpose theory even if *** did not have to enlarge its facilities to service *** and the only reason *** facilities were enlarged was to insure *** with a more reliable source of service, *** still did not have the significant motivation. The "contributions" were motivated by the desire of *** to achieve a business purpose, viz., to obtain a more reliable source of electricity to operate its rapid transit system. Also, there was a definite nexus

between such "contributions" and business of providing an efficiently operated mass transit system. Id .

In the instant case, the *** made the "contributions" to *** so that the utility could provide the sewage disposal services necessary to the housing development. Thus, the motivation was one of a business necessity. Because the benefit in the form of the right to receive necessary sewage services is a direct benefit, the "contributions" represent, like the contributions in the *** transaction, the cost of obtaining that benefit. Such amounts, therefore, cannot be considered to be contributions in aid of construction but should be considered as section 61 income. See also ***, G.C.M. 38482, I-4861-77 (Aug. 21, 1980).

II

During our consideration of the matter here, we learned that a technical advice memorandum was issued in this case that reached results inconsistent with what we have stated here. The memorandum dealt with two different payments to the instant partnership, one by a *** and the other by the ***. In that memorandum, it was concluded that the payment by the *** qualified as a contribution to capital to the extent that it was not a connection fee, but that the payment by the *** did not so qualify because it was a connection fee. Under our rationale neither payment should have qualified as a contribution to capital under section 118 or the case law, regardless of whether the payment was a connection fee. We are bringing this to your attention so that our positions may be reconciled and consistency achieved. Similarly, we are calling your attention to P.R. 8038037 that also is inconsistent with our analysis.

Copies of G.C.M. 37354, ***, and G.C.M. 38482, *** are attached for your convenience. [Ed. note: GCMs 37354 and 38482 were not attached .]

DONALD J. DREES, JR.

Acting Director

By:

JEANNE L. DOBRES

Technical Assistant to the Director

Interpretative Division

1. The term "regulated public utility" has the meaning given such term by section 7701(a)(33); except that such term shall not include any such utility which is not required to provide electric energy, gas, water or sewerage disposal service to members of the general public (including in the case of a gas transmission utility, the provision of gas services by sale for resale to the general public) in its service area. I.R.C. s 118(b)(3). Section 7701(a)(33) defines a regulated public utility as a corporation meeting certain requirements.

2. Proposed Reg. s 1.118-2(a)(1) provides that for purposes of section 118(b), the term "contribution in aid of construction" means an item or amount contributed to a regulated public utility which provides water or sewerage disposal services to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility's water or sewerage disposal facilities. Section 118(b)(3) provides further that such term shall not include amounts paid as customer connection fees (including amounts paid to connect the customer's line to an electric line, gas main, a steam line, or a main water or sewer line and amounts paid as service charges for starting or stopping services).

3. Section 118(b) was added by the Tax Reform Act of 1976. P.L. 94-455 s 2120(a).

4. Income was then read as applying only to the gain derived from capital, labor, or both. Eisner v. Macomber, 252 U.S. 189, 207 (1920).

5. While, initially, the line of judicial decisions started with a narrow reading of the gross income provision, thereafter the cases turned on a corporation's basis in property purchased with "contributed" funds notwithstanding that such funds were excluded from gross income. See United States v. Chicago, Burlington & Quincy Railroad Company.412 U.S. 401 (1973) and the cases there cited.

6. See Commissioner v. Kowalski, 434 U.S. 27 (1977); In Re Chrome Plate v. District Director,614 F.2d 990 (5th Cir. 1980) aff'g442 F. Supp. 1023 (W.D. Tex. 1977), cert. denied, 449 U.S . 842 (1980).

7. Without analysis, some commentators suggest that the rationale of the decisions would be equally applicable to situations in which contributions by third parties are made to unincorporated taxpayers. See 4 J. Mertens, Law of Federal Income Taxation s 23.21(e) n. 6 (rev. ed 1980); Taxation of Nonshareholder Contributions to Corporate Capital, 82 Harv. L. Rev. 619, 628 n.49 (1970). See also W. McKee, W. Nelson and R. Whitmire, Federal Taxation of Partnership and Partners, para S9.08[2][W].

8. Because *** was an electric utility and at the time of the transaction section 118(b) only applied to water and sewage disposal utilities, *** could only come under section 118(a).