Agenda Item #:_____

Staff Report
City of Manhattan Beach

TO: Honorable Mayor Fahey and Members of the City Council

THROUGH: Geoff Dolan, City Manager

FROM: Robert V. Wadden, Jr., City Attorney
Bruce Moe, Finance Director
Neil Miller, Director of Public Works
Dana Greenwood, City Engineer
Stephanie Katsouleas, Senior Civil Engineer

DATE: August 2, 2005

SUBJECT: Consideration of Potential Tax Liability for Future Underground Utility Assessments

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RECOMMENDATION:
Staff recommends that the City Council proceed to not include the IRS tax component in future utility underground assessment districts. The reasons for this recommendation and other options are described in the balance of this report.

FISCAL IMPLICATION:
The fiscal implications of this issue are discussed below.

BACKGROUND:
As planned, the property owners of parcels located in Districts 2, 4 and 6 will vote later this fall on whether to form assessment districts for the purposes of undergrounding utilities in their neighborhoods. Additionally, design work for Districts 7-10 will commence this August. Initiation of District 11 and 12 (and any future districts) design plans will depend on Edison's schedule and funding availability, but is not expected to start before summer 2006. As was the case with Districts 1, 3 and 5, the question of how to address the additional Income Tax Contribution Component (ITCC) that could potentially be imposed by the IRS for the material upgrades and improvements has been raised. A private letter ruling (see Attachment A) was issued by the IRS on April 6, 2005 clarifying its tax position regarding residential undergrounding of utilities. It is worth noting that the private letter ruling Edison received did not specifically identify Districts 1, 3 and 5, suggesting it may be applicable to any resident-driven UUAD project. At the bottom of page two the IRS stated, "…we conclude that the payments made by City [Manhattan Beach] to Corp A [Edison] to underground the overhead electrical lines and related equipment fall within the public benefit exception described in the House Report and in Notice 87-82 and are not a

CIAC[1] under section 118(b)." This ruling confirms that residents in Districts 1, 3 and 5 will not be taxed for the system upgrade. Because the same tax issue has now arisen for Districts 2, 4 and 6 and all future districts, staff called the IRS representative who issued the Private Letter Ruling (David McDonnell) to glean insight to the likelihood of future UUADs being taxed. Mr. McDonnell's response was very clear. He stated that if the tax liability concern is the same (i.e., undergrounding utilities for existing parcels rather than for new developments), then the utility would not be assessed taxes on the upgrade based on current law. He also stated that if the ruling were to change, application of the new law would not be retroactive to system upgrades constructed prior to the new ruling's effective date.

Staff recommends proceeding with current and future utility underground districts without consideration of the Income Tax issue given the strength of the IRS Private Letter Ruling.

DISCUSSION:

Based on the IRS ruling discussed above (also see Attachment A), the overall risk that the IRS would, in the future, collect taxes on these improvements is minimal. However, staff is presenting City Council with three options as follows:

Option	Benefit	Risk/Drawback
1. **Do not** include the potential IRS tax component in the final assessment presented to residents	The final assessment amount presented to property owners is less, thereby maximizing the total number of residents who may vote to form the Districts. Assuming the Districts form, the City is reimbursed for all funds associated with bringing the Districts forward.	While the risk is minimal, should the IRS change its ruling for future districts, the City would be liable for the entire tax assessed.[2] This amount is based on the total cost of the improvements, and is projected to be $700,000 - $950,000 for each of the three Districts.
2. **Do** include the potential IRS tax component in the final assessment presented to residents	The City assumes no risk should the IRS change its ruling for future districts. The amount is collected from residents and available for collection from the IRS for 13 years. Fees are returned to residents at the end of 13 years if not collected by the IRS.	The final assessment amount presented to property owners is approximately 18% higher (or up to $5,000 per parcel), thereby likely decreasing the total number of residents who will vote in favor of the Districts. The City runs a higher risk of losing expended funds ($247,746 + staff time) should the Districts fail to form.

[1] CIAC – Contribution in aid of construction

[2] Edison will not accept liability for the potential income tax, and will require the City to indemnify it for the tax if it is levied by the Internal Revenue Service.

Option	Benefit	Risk/Drawback
3. Seek a new Private Letter Ruling from the IRS regarding Districts 2, 4 and 6 and all future districts; Collect the tax component up front.	The issue is finalized in a timely manner for each district. Residents know the risk, and may be reimbursed immediately for the tax component (but not the cost of the private letter ruling) should the ruling come back favorably. The City assumes no financial risk for the tax.	The higher assessment cost is still presented to residents and collected until the ruling is issued, potentially decreasing the number of residents in favor of forming the District. Residents must pay the tax as well as the Private Letter Ruling as part of their assessment. The Ruling fee was $50,000 previously. This translates into approximately $77 per parcel (split evenly) if the IRS fee remains the same.

Staff recommends that the City Council choose option number 1. Further contributing to this issue is the significantly higher cost of construction. Already, staff estimates that the upcoming assessments (to be determined) for Districts 2, 4 and 6 will be at least double what residents in Districts 1, 3 and 5 have paid, and will likely be $10,000 – 18,000 or higher per parcel. Adding additional taxes on top of increased construction fees will most likely have a negative effect.

A second private letter ruling request to the IRS filed jointly by the City and Edison would provide additional resolution to the taxability issue. However, staff does not expect the ruling to be different than the ruling already received. If this option is chosen and we receive another positive response from the IRS, the liens will be removed and any prepaid ITCC funds will be returned. If a negative response is received, then the City will have already collected the tax. A private letter ruling can take up to 18 months to complete, although the last one was received within 6 month. While there is no guarantee, Edison believes that if the City again seeks the private letter ruling, the IRS would most likely issue a favorable ruling consistent with prior letter rulings. If Council directs staff to pursue this option, a letter to Edison from the City requesting the ruling from the IRS will be sent once the District is formed.

Lastly, staff did question how Hermosa Beach addressed the potential IRS tax regarding its UUAD projects and found that the city elected to assume the financial risk on behalf of its residents. Thus, the additional IRS tax component was not included in the final assessment amounts presented to the residents of Hermosa Beach.

CONCLUSION:

Staff recommends proceeding on the basis of Option 1 (**Do not** include the potential IRS tax component in the final assessment presented to residents) for all future districts. Staff feels that a future unfavorable ruling from the IRS is remote in light of its recent ruling regarding the tax liability for Districts 1, 3 and 5. This issue must be resolved prior to finalizing the Assessment Report and initiating voting procedures for Districts 2, 4 and 6 (which are currently scheduled for the beginning of September). Without resolution of this issue, the final assessment amounts cannot be determined.

Attachment A: IRS Private Letter Ruling, April 6, 2004.

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 118.02-02, 118.01-02

Mr. Anthony L. Smith
Vice President, Tax
Southern California Edison Company
2244 Walnut Grove Avenue
Rosemead, CA 91770
In Re:
Southern California Edison Company
2244 Walnut Grove Avenue
Rosemead, CA 91770

Person To Contact:
Mr. David H. McDonnell, ID No. 50-22860R
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Refer Reply To:
CC:PSI:B05
PLR-163036-04
Date:
April 06, 2005

Parent = Edison International
EIN: 95-4137452
Corp A = Southern California Edison Company
EIN: 95-1240335
City = Manhattan Beach, California

Dear Mr. Smith:

This letter responds to a letter, dated November 29, 2004, submitted on behalf of Corp A by its authorized representatives, requesting a ruling under section 118 of the Internal Revenue Code.

FACTS

Corp A is a subsidiary of Parent and a member of the Parent affiliated group that files a consolidated return. Corp A is in the business of transmitting and distributing electric power.

City has an ordinance that allows businesses and residences in each district of City to vote for the undergrounding of utility lines. The stated purpose of the ordinance is "the improvement of public safety, the preservation of ocean views by the removal of poles and overhead lines, and the overall enhancement of the seashore community appearance." As of the request, certain districts in City have voted for undergrounding. City issued tax-exempt bonds and will use the proceeds to pay Corp A for the undergrounding. Special assessments on property in the districts that voted for undergrounding will be used to repay the bonds.

LAW AND ANAYSIS

Section 61(a) and section 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b) provides that for section 118(a) purposes, the term "contribution to the capital of the taxpayer" does not include any contribution in aid of construction (CIAC) or any other contribution as a customer or potential customer.

The House Ways and Means Committee Report for the Tax Reform Act of 1986 explains that property, including money, is a CIAC (rather than a capital contribution) if it is transferred to provide or encourage the provision of services to or for the benefit of the person transferring the property. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (Vol. 2) C.B. 644 (the House Report). A utility has received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services; if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received; or if the receipt of the property otherwise causes the transferor to be favored in any way. Id. However, a transfer of property is not a CIAC where it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfer. Id.

Notice 87-82, 1987-2 C.B. 389, provides that a payment received by a utility is not a CIAC if it does not reasonably relate to the provision of services by the utility or for the benefit of the person making the payment, but rather relates to the benefit of the pubic at large. Notice 87-82 provides as an example of a payment benefiting the public at large a relocation payment received by a utility under a government program to place utility lines underground. In that situation, the relocation payment is not considered a CIAC where the relocation is undertaken for purposes of community aesthetics and public safety and does not directly benefit particular customers of the utility in their capacity as customers.

The payments made by City to Corp A to underground the overhead electrical lines and related equipment will benefit the public at large primarily by improving community aesthetics and public safety. Therefore, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment fall within the public benefit exception described in the House Report and in Notice 87-82 and are not a CIAC under section 118(b).

Next, we must decide whether the payments qualify as a contribution to capital under § 118(a).

The legislative history of § 118 provides, in part, as follows:

> This [§ 118] in effect places in the Code the court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 18-19 (1954).

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes were part of the price of service rather than contributions to capital. The case concerned customers' payments to a utility company for the estimated cost of constructing service facilities (primary power lines) that the utility company otherwise was not obligated to provide. The customers intended no contribution to the company's capital.

Later, in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), the Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. Id. at 591.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973), the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The court recognized that the holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co. The Court in Chicago, Burlington & Quincy Railroad Co. found that the distinguishing characteristic between those two cases was the differing purpose motivating the respective transfers. In Brown Shoe Co., the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co., since the transfers were made with the purpose not of receiving direct services or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in Chicago, Burlington & Quincy Railroad Co. also stated that there were other characteristics of a nonshareholder contribution to capital implicit in Detroit Edison Co. and Brown Shoe Co. From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Fifth, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. Chicago, Burlington & Quincy Railroad Co., 412 U.S. at 413.

The payments made by City to Corp A to underground the overhead electrical lines and related equipment contain the characteristics of a nonshareholder contribution to capital described in Chicago, Burlington & Quincy Railroad Co. First, the undergrounded lines and related equipment will become a permanent part of Corp A's working capital. Second, the payments are not compensation for services because, after the payments are made, Corp A will not be required to provide any services it is not providing at the present time. The required undergrounding is not necessary other than as part of City's undergrounding program to improve community aesthetics and public safety. Third, the payments are a bargained-for exchange, because Corp A and City bargained at arms-length on the location and cost of the undergrounding of the lines and related equipment. Fourth, the payments foreseeably will result in a benefit to Corp A commensurate with their value because they will be used as part of Corp A's electrical distribution system over which it provides electricity for sale to its customers. Fifth, the undergrounded lines and related equipment will be used by Corp A in its trade or business to produce income.

Therefore, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment are a contribution to the capital of Corp A under section 118(a).

CONCLUSION

Accordingly, based on the foregoing analysis and the representations made, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment are not a CIAC under section 118(b) and are a contribution to the capital of Corp A under section 118(a).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be filed with Parent's federal income tax return for the taxable year in which the contribution is made.

In accordance with the power of attorney on file with this ruling request, a copy of this letter is being sent to Parent's authorized representatives.

Sincerely,

Harold E. Burghart

HAROLD E. BURGHART
Senior Advisor, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):
Copy of this letter
Copy for section 6110

cc:

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