Agenda Item #: _____

Staff Report
City of Manhattan Beach

TO: Honorable Mayor Fahey and Members of the City Council

THROUGH: Geoff Dolan, City Manager

FROM: Bruce Moe, Finance Director
Neil Miller, Public Works Director

DATE: May 17, 2005

SUBJECT: Accept Internal Revenue Service Private Letter Ruling Determining that Underground Utility Assessment Districts 1, 3 & 5 are Not Taxable, and Authorize Reimbursement of Prepaid Tax Funds to Property Owners ($136,007)

RECOMMENDATION:
Staff recommends that the City Council receive and file the Internal Revenue Service's letter ruling of non-taxability for Underground Utility Assessment Districts 1, 3 & 5, and authorize reimbursement of tax funds prepaid by property owners.

FISCAL IMPLICATION:
Funds totaling $136,007 were prepaid by 97 property owners for the income tax portion of their assessments in Underground Utility Assessment Districts 1, 3 & 5. The City has held those funds in trust pending the IRS's ruling on the taxability of the improvements. Now that the IRS has made a determination that the improvements are not taxable, we will return the funds to the property owners.

BACKGROUND:
In March 2004, property owners in Underground Utility Assessment Districts 1, 3 & 5 voted to assess themselves for the purpose of undergrounding utilities in their respective neighborhoods. The assessment included two components: 1) the base assessment for the physical improvements, and 2) an Income Tax Contribution Component (ITCC). The income tax component addressed possible tax ramifications for Southern California Edison as a result of third parties paying for improvements to their facilities (the value of that work may be considered taxable income for Edison). In order to resolve the taxability issue, Southern California Edison, in cooperation with the City, requested a Private Letter Ruling from the IRS.

DISCUSSION:
Edison has received the ruling from the IRS (see Attachment "A"), and they have determined that the facilities conversion is not a taxable event, and therefore no additional assessment will be necessary. Any prepaid tax funds, which are being held in trust by the City, may now be returned to the property owners. No liens were placed on the subject properties.

At the time of the assessment, property owners had the choice of prepaying one or both components of the assessment, or adding the base assessment to the property tax roles (the tax component would have

been added to the tax roles separately in the event the activity was deemed taxable by the IRS). Now that the final determination on taxability has occurred, we will begin returning prepaid tax funds, which total $136,007. There are 97 property owners who will be receiving refunds for the prepayment of taxes. Checks will be issued within the next 4 weeks.

Attachment: A – Private Letter Ruling from the IRS

cc: Mark Young, Gardner, Underwood & Bacon
Kevin Civale, Hawkins, Delafield & Wood
Frank Lauterbur, UBS
Jeff Bower, UBS

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
Telephone Number:
(202) 622-3040
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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