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MEMORANDUM OF LAW

DATE: April 2, 2004

TO: Larry Gardner, Director, Water Department

FROM: City Attorney

SUBJECT: Contribution In Aid of Construction [CIAC] Tax on Relocation of SDG&E Facilities

QUESTION PRESENTED

Should the City of San Diego [City] pay a contribution in aid of construction [CIAC] tax on payments to SDG&E for the relocation of overhead lines, a guy pole, and a transformer where the relocation was necessary to upgrade and expand the Miramar Water Treatment Plant?

SHORT ANSWER

No. As the payments were not made to SDG&E to provide or to encourage new service and were for the "public benefit," they are not contributions in aid of construction but contributions to capital and properly excluded from income under Internal Revenue Code section 118(a). City, therefore, should not pay a CIAC tax.

DISCUSSION

I. Background

The City of San Diego Water Department's [Water] Miramar Water Treatment Plant began operation in 1962. The Miramar Water Treatment Plant [WTP] is the sole provider of drinking water to an estimated 500,000 customers in the northern section of City. The WTP currently produces 140 million gallons of water per day [mgd].

For the following reasons, Water designed and implemented a plan to upgrade and expand the WTP: 1) recent changes in federal and state drinking water regulations require that treatment plants meet new standards; 2) increases in population in the service area have resulted

in demands that exceed existing capacity; and 3) the facility and associated equipment are approaching the end of their useful lives and need to be upgraded or replaced.

During the upgrade and expansion, Water requested that SDG&E relocate certain facilities in order to accommodate the construction. Electrical overhead lines and a transformer located on the east side of the main street were relocated to allow for the placement of a new filter. A wooden guy pole supporting a transmission line, a guy line, and an anchor were removed as the guy line and anchor interfered with construction. A steel pole without guy wire or anchor replaced the wooden counterpart. A transformer was moved ninety feet to allow for grading operations. The relocations did not provide Water with new or additional electrical service.

SDG&E charged Water $245,797 (including CIAC tax) to relocate the facilities described. By including the CIAC tax in the charges, SDG&E treated the payments for the relocation as taxable income. Water contends that the payments to SDG&E were not contributions in aid of construction but contributions to capital, specifically excluded from income under I.R.C. section 118(a).

II. Analysis

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, however, is not defined in the Internal Revenue Code. An examination of the case law provides some insight into the 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.

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.

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 is 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 Co. v. Commissioner of Internal Revenue*, 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 recent 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.[1] 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, 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 nonshareholder 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.

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[1]In a memo dated April 10, 2000, Assistant City Attorney Les Girard addressed the tax treatment of payments for undergrounding utilities under Rule 20b. He concluded that the payments should not be subject to the CIAC tax. City Att'y Memo (April 10, 2000).

CONCLUSION

Payments to relocate utility facilities in order to expand the WTP meet both requirements of the public benefit exception. The payment is not a prerequisite to obtaining electric service. WTP already has electric service. In addition, the payment is intended to provide a public benefit. The relocation of lines allows for the expansion of a municipal water treatment facility. The expansion of the facility will provide larger quantities of cleaner water, promoting health of the community and providing a benefit to the public at large. As the payments to SDG&E for the relocation of the utility facilities are not "the payment for services" and provide a "public benefit," they fall within the public benefit exception. Thus, the payments are non-taxable contributions to capital under I.R.C.section 118(a), and City should not pay the CIAC tax included in the charges for the relocation work.

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By
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