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Decision 92-09-030 September 2, 1992

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

John Elbertse, Johanna Elbertse, AMERICAN EAGLE WHEEL CORPORATION, Complainants, vs. SOUTHERN CALIFORNIA EDISON COMPANY, GTE CALIFORNIA, INC., Defendants.	Case 91-05-027 (Filed May 10, 1991)

Spray, Gould & Bowers, by Peter Osborn, Attorney at Law, for American Eagle Wheel Corporation, complainant.
Elaine M. Lustig, Attorney at Law, for GTE California, Inc. and James P. Scott Shotwell, Attorney at Law, for Southern California Edison Company, defendants.
James B. Gallagher, for Southern California Water Company, interested party.

O P I N I O N

Complainants John Elbertse and Johanna Elbertse own and operate complainant American Eagle Wheel Corporation (AEWC). In this opinion, we shall refer to complainants collectively as AEWC. AEWC seeks a refund from defendant Southern California Edison Company (Edison) of approximately $15,400 which was paid by AEWC to Edison as the federal income tax portion associated with a contribution in aid of construction (CIAC) used to pay for the cost of undergrounding electric facilities in front of AEWC's property in the city of Chino.

At issue is whether payment to Edison for the undergrounding of AEWC's facilities is taxable to Edison, or whether such payment is a contribution of capital to Edison, and,

therefore, not taxable pursuant to Internal Revenue Code Section 118, subdivision (a).[1] If the payment for the undergrounding of the utility facilities is not taxable, then Edison may not include a 28% gross-up factor in its charges. By agreement of the parties, GTE California, Inc. has been dismissed as a defendant. Public hearing was held before Administrative Law Judge Robert Barnett.

The Tax Reform Act of 1986[2] amended Section 118(b) of the Internal Revenue Code to specifically provide that CIACs made after December 31, 1986 by customers or potential customers of a public utility are not contributions to capital as defined in Section 118(a) and, thus, must be included in gross income of the recipient utility:[3]

> "For purposes of subsection (a), the term 'contribution to the capital of the taxpayer' does not include any contribution in aid of construction or any other contribution as a customer or potential customer."[4]

Congress' principal motivation in revising Section 118(b) was the belief that CIACs, in substance, represent receipts by utilities of prepayments for future services.[5] In the House

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1 All statutory references herein are to the Internal Revenue Code, unless indicated otherwise.

2 Tax Reform Act of 1986, Pub. L. 99-514, § 2, 100 Stat. 2095 (1986).

3 Prior to 1986, Section 118(b) of the Internal Revenue Code specifically excluded all CIACs made by customers or potential customers from a regulated public utility's taxable income.

4 I.R.C. § 118(b) (1986).

5 I.R.S. Notice 87-82, 1987-2 C.B. 389. IRS Notice 87-82 provides the most definitive statement of what constitutes a taxable CIAC under Section 118(b).

Report, Congress defined gross income as "the value of any property, including money, that [a utility] receives to provide or encourage . . . the provision of, services to or for the benefit of the person transferring the property."[6]

The most definitive authority on whether such payments are taxable is Internal Revenue Service Notice 87-82 (cited by both parties) which provides in relevant part as follows:

> "If, for example, it can be shown that a particular payment received by a utility does not reasonably relate to the provision of services of such utility to or for the benefit of the person making the payment but rather relates to the benefit of the public at large, the payment is not treated as CIAC under section 118(b) of the [Internal Revenue Code]. For example, relocation payments received by a utility under a government program for placing utility lines underground shall not be treated as CIAC where such relocation is undertaken for purposes of community esthetics and public safety and not for the benefit of particular customers of the utility in their capacity as customers. See Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950) (payments made by certain community groups as an inducement to location or expansion of taxpayer's factory were held to be contributions to taxpayer's capital because the payments were made to benefit the community at large and not for services). Similar principles apply where the utility is being reimbursed for the costs of relocating utility lines to accommodate the construction or expansion of a highway and not for the provision of utility services."
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> "Similarly, assume that a potential customer of a utility is required (either by the utility or by a governmental entity) to pay the utility

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6 H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 644 (1985), as cited in I.R.S. Notice 87-82.

> for the cost of relocating utility facilities in order to obtain access to utility services for a site the customer is developing. Since the payment of the relocation fees is a prerequisite to obtaining utility services, the payment is a CIAC and is included in the utility's income, regardless of whether the particular utility facilities being relocated are related to the site the customer is developing."

Chapter 13.32, "Underground Utility Construction," of the Chino City Ordinance requires property owners to underground utility lines serving their property when the property is improved. The City found that "the public interest and welfare require that all utility lines and related facilities, . . . to be constructed within the City upon property which is undeveloped, and certain developed property . . . shall be placed underground . . ."[7] The city specifically requires that:

> "All electrical . . . lines which provide service to the property being developed, improved, or redeveloped shall be installed underground except as provided in this chapter. The owner or developer shall be responsible for compliance with this chapter and shall arrange with the serving utilities for such installation."

CIACs constitute the value of any property, including money, provided to a public utility for the purpose of expanding, improving or replacing a utility's facilities and the associated income tax cost component (ITCC). Pursuant to the Commission's decision in Investigation (I.) 86-11-019, commonly referred to as the Tax OII, Edison is authorized to collect from customers the amount of tax a customer causes to be imposed upon Edison by

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7 Chino, CA, Code § 13.32.010 "Findings of Council" September 8, 1974.

providing a CIAC.[8] This allows the utility to remain whole without burdening the ratepayers. Preliminary Statement M, "Income Tax Component of CIAC Provision" of Edison's Commission-approved Tariff Schedules, reflects this requirement:

> "All [CIACs] made to the Company pursuant to its tariffs shall include a cost component to cover the Company's estimated liability for Federal and State Income Tax on CIACs on or after . . . January 1, 1987 . . ."

Edison's ratepayers are not responsible for any uncollected taxes. Accordingly, Edison collects an ITCC on all CIACs to cover Edison's liability for all federal and state income tax, unless it can clearly be shown that the transaction is not taxable.

Complainant Johanna Elbertse testified that in 1986, AEWC purchased property on Benson Avenue in the city of Chino. At the time of the purchase, the property was a strawberry field. At that time, Edison had electric power lines in place overhead along Benson Avenue in front of AEWC's property. In January 1987, AEWC obtained a special conditional use permit from Chino to construct a plant to manufacture automobile wheels. Construction began in early 1988. During the construction period, electric service to the site was provided through the existing overhead utility lines which served the property. The building permit that was issued to AEWC had as a condition that "all utility lines and related facilities shall be located underground in accordance with city code." AEWC interpreted that clause to mean that new electric facilities which were required to be installed in connection with the construction would be underground, which was done. AEWC did not interpret the provision to mean that existing facilities had to

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8 Order Instituting Investigation No. 86-11-019, D.87-09-026, dated September 10, 1987. (25 CPUC 2d 299.)

be undergrounded. Construction of the building was completed in late 1988.

After the building was constructed, AEWC sought permission to install a propane tank on the property. In February 1989, Chino approved the installation with the requirement that AEWC "obtain design and plan approval from appropriate utility companies for undergrounding all utility lines adjoining and interior to the project, including power lines of 34.5 kV or less, in accordance with city code § 13.32.040." AEWC interpreted this permit as requiring it to underground the utility facilities in front of its property on Benson Avenue.

AEWC resisted paying for placing the lines underground. After discussions with Chino, the city demanded payment for the undergrounding; the city would then pay Edison. During all this time, the property was being served through the existing overhead electric lines. In September 1989, AEWC paid $73,929 to Chino for the undergrounding. (Of this amount, $3,505 will be refunded as an overpayment.) The total charged by Edison included 28%, or approximately $15,400, as the income tax component of the payment. AEWC claims that the CIAC is for the public benefit and is not a taxable transaction; therefore, the 28% income tax component should be refunded to AEWC.

A Commission employee, Joe Cabrera, testified on behalf of AEWC. He is a regulatory analyst in the Division of Ratepayer Advocates (DRA) tax section and is responsible for developing estimates for income tax, property tax, and other taxes in utility rate cases and other matters that come before the Commission. He testified that he is familiar with the facts of this case and in his opinion the payment by AEWC to underground the electric lines was not a taxable event and should not have been charged a tax gross-up. In his opinion, the transaction comes within the exception of Notice 87-82 as relating to the relocation of utility facilities because the motivating factor of the undergrounding is

the city's desire to enhance community aesthetics, which provide a benefit to the public at large. In his opinion, although AEWC received a benefit from the grant of construction permits, the primary motivating factor for the undergrounding is the policy of Chino. He could not, however, provide a recommendation as to who should ultimately pay the tax and penalties should the IRS determine the transaction to be taxable.

Edison presented a senior tax analyst in its tax department, a CPA. In the witness' opinion, the contribution of AEWC is a taxable transaction. He said that IRC Section 118(b) states that any contribution by a customer cannot be excluded from gross income under Section 118(a), which means that it is not a nontaxable contribution to capital, which means that it is taxable under Section 61(a), which defines gross income. In forming his opinion, he relied on IRS Notice 87-20 which interprets Section 118. He said that the notice provides an exception to Section 118(b), that contributions in aid of construction are not taxable if they are not made in connection with the provision of services, including situations where it is clearly shown that the benefit of the public as a whole was a primary motivating factor in the transfer. However, it is taxable, under the exceptions set forth in the notice, "if the receipt of the property is a prerequisite to the provision of services or if the receipt of the property otherwise causes the transferor to be favored in any way." If the person making the transfer is benefited in any way, then that person is considered as receiving a provision of services.

In the witness' opinion, AEWC benefited from the transaction by being issued a permit to construct its plant and a permit to place a propane tank on its property. In the witness' opinion, the IRS will interpret the facts of this case as being a benefit to AEWC and, therefore, taxable. He said that he spoke to Chino officials who told him that AEWC was required to underground

the overhead line facilities when they requested a permit to build the original facility.

A regulatory specialist for Edison testified that in the first instance the customer service department of Edison makes the determination whether or not a transaction is taxable. If a questions arises regarding whether a transaction is taxable, the matter is referred to one of Edison's tax attorneys. The witness testified that if a city desired to underground lines pursuant to Rule 20a and 20b of Edison's tariff money paid by the city to Edison under Rule 20b would not be considered taxable. He said that situations such as AEWC's in the city of Chino are not unusual and that there have been hundreds of instances where Edison has collected the tax gross-up. In no instances has Edison failed to collect the tax gross-up. He said that in one instance, Edison joined in a request for a private ruling from the IRS in a situation where the contributor desired a ruling and was willing to pay for it. The cost of obtaining an IRS ruling could be as high as $15,000 in the AEWC situation.

Discussion

AEWC cites Notice 87-20 as its principal authority and refers to the following language:

> "(T)he legislative history to the Act provides that the repeal of section 118(b) of the 1954 Code does not affect transfers of property which are not made in connection with the provision of services, including situations where 'it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers.' (cite omitted) The Notice goes on to state that 'relocation payments received by a utility under a government program for placing utility lines underground shall not be treated as CIACs where such relocation is undertaken for purposes of community esthetics and public safety and not for the direct benefit of particular customers of the utility in their capacity as customers.'" Notice 87-82, p. 2.

AEWC asserts as its first issue that it was virtually forced to underground its utility facilities because of the city of Chino's policy of requiring the undergrounding of utility facilities for the benefit of the public whenever it can lawfully do so. Under the Chino City Ordinance, the city has declared that undergrounding is "in the public interest and welfare." A letter from the city attorney explains that the purpose behind the ordinance is to improve community esthetics and public safety. There is, in AEWC's opinion, no question that its undergrounding was required for the benefit of the public at large rather than AEWC. Indeed, AEWC vigorously resisted the efforts of the city to require the undergrounding.

The second issue raised by AEWC is whether the undergrounding was related to the provision of utility service. It is undisputed that AEWC was receiving excellent utility service from Edison through overhead lines prior to the undergrounding. It could have continued to receive this same service through the overhead lines. The lines that were placed underground ran along the street in front of the subject property. Nothing related to utility service required the lines to be placed underground.

Notice 87-82 states that "overhead utility lines may be placed underground under a government program undertaken for reasons of public safety" without the contribution being subject to federal income tax.[9] AEWC claims that its undergrounding comes directly within this example. Chino has a program, under City Ordinance Chapter 13.32 which was enacted pursuant to Street & Highways Code section 5896.1 et seq. and Government Code

9 This is just an example of one type of transaction that is not taxable. AEWC argues that it is clear from the context of the Notice that this example is not intended to exclude other types of transactions. See e.g. Federated Dept. Stores v. Commissioner of Int. Rev. (1970) 426 F.2d 417, 421.

section 38793.[10] This program allows the city to require land owners to underground utility facilities for the benefit of the public whenever a special use permit is issued by the city. Thus, AEWC's undergrounding is not subject to federal income tax under an explicit example cited in Notice 87-82.

AEWC anticipates that Edison may take the position that the undergrounding project is taxable because the undergrounding benefited AEWC because it allowed AEWC to comply with the city's condition for its special use permit. AEWC believes that this "benefit" is not the type of benefit contemplated by the Notice. It asks us to assume, for example, that a city undertakes a program to underground utility lines and enacts a tax upon its residents to fund the program. It might be said that there is a benefit to the residents from complying with the law and not being in default of their taxes, but in the opinion of AEWC, this is not type of benefit referred to in the Notice. It must be a benefit relating to the provision of utility service.

In support of its argument, AEWC cites Federated Dept. Stores v. Commissioner of Int. Rev. (1970) 426 F.2d 417, where the court held that a contribution was unrelated to the services provided by the recipient corporation and therefore not taxable when a realty company gave money to a department store for it to construct a new store near one of the realty company's centers. The purpose of giving the money was the hope on behalf of the realty company that the existence of the new department store would promote its financial interests. The court held that the payment was a nontaxable contribution because "any benefit expected to be derived by [the realty company] was so intangible as not to warrant

10 Street & Highways Code section 5896.1 et seq. and Government Code section 38793 provide generally that a city may enact ordinances requiring the undergrounding of utility facilities.

treating its contribution as a payment to taxpayer for future services." Federated at 421.

Edison argues that AEWC's CIAC to pay for the undergrounding of existing overhead electrical lines and Edison's receipt of such money constituted a provision of service primarily for AEWC's benefit and, thus, is a taxable CIAC. IRS Notice 87-82 provides that transfers of property made in connection with the provision of service in situations where it cannot be clearly shown that benefit to the public as a whole was the primary motivating factor in the transfer will result in the recognition of a CIAC, which must be included in gross income of the recipient utility. AEWC's CIAC to underground Edison's overhead lines along Benson Avenue was connected with Edison's provision of service to AEWC and was for the benefit of AEWC which was expanding its facilities. The facts in this case demonstrate that AEWC's request to underground its lines was primarily for the purpose of receiving permits to construct buildings and install a propane tank on its property for business use, and not primarily for the benefit of the public or community.

We agree with Edison. Edison is the taxpayer and Edison is the entity that bears the responsibility for determining if a tax is due and the risk of paying interest and penalties if it is wrong. In the proceeding in which we considered the general position that utilities should take regarding which CIAC are taxable contributions, we said "Our policy is that the utility should not put the ratepayers at risk for CIAC taxes to an extent greater than we authorize by this decision. The best procedure to reduce ratepayer risk is to require the utilities to collect the tax gross-up on all contributions." (D.87-09-026, p. 67; 25 CPUC 2d at 332.) And we made it clear that Edison's shareholders are responsible for any uncollected CIACs: "[I]f the utility believes that a particular contribution is not subject to tax, it need not collect the tax gross-up. But if it has made the wrong decision

and the IRS assesses the tax plus interest and penalties, the entire amount will be a charge against the shareholders, not the ratepayers." (25 CPUC 2d at 332.) We said that "it would be imprudent for this Commission to find that one form of [CIAC] transaction or another would avoid the tax. That decision is for the IRS and the courts." (25 CPUC 2d at 335-36.)

Complainant has not persuaded us to change our holding. We are not the arbiter of what is or is not taxable. For us to rule in complainant's favor and order Edison to refund the tax portion of the CIAC to AEWC, and if we were wrong, we would, of necessity, have to authorize Edison to recover the tax and penalty from the ratepayers. Schemes for indemnification by the contributor have not been shown to be feasible.[11] We recognize the dilemma caused by our position in regard to contributors who cannot afford to pay for a private IRS ruling, or when the economics of a particular contribution make it impractical to seek a ruling. Edison has no incentive to waive the gross-up and every incentive to collect it; and in most instances the contributor has no practical remedy.

All of those factors were before us when we decided D.87-09-026. (See the discussion, 25 CPUC 2d at pp. 331-33.) The issues have not changed, nor has the law. D.87-09-026 was decided five years ago, yet we are cited to no case interpreting the 1986 amendment to IRC section 118(b). The only cases cited by either party were decided prior to 1986. Without guidance from the IRS more specific than IRS Notice 87-82, we can neither substitute our judgment for Edison's, nor predict with confidence that the IRS would not tax and penalize Edison should Edison not declare as

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11 If indemnification were feasible, Edison would be put in the contradictory position of not including CIAC in taxable income when indemnified and including it when not indemnified. We don't believe the IRS would permit this to last long.

income and pay a tax on AEWC's contribution. AEWC did receive a benefit from the transfer (albeit not from the undergrounding). But for the payment of CIAC, AEWC would not have received a permit to build and occupy its facilities on Benson Avenue in Chino. The pivotal issue before us is not whether we find that AEWC received or did not receive a benefit from the transfer; the pivotal issue is whether the IRS will assess a tax under the circumstances of this case. That is a matter for the IRS, not the Commission.

Findings of Fact

1. In 1986 AEWC purchased property in the city of Chino. At that time, Edison had electric power lines in place overhead in front of AEWC's property.

2. Between 1987 and 1989 AEWC was issued permits by the city of Chino to construct and occupy a facility. The permits were conditioned upon AEWC's undergrounding all utility lines adjoining and interior to the facility.

3. The permit requirement was pursuant to Chapter 13.32 of the City Ordinance of Chino which declared that the public interest and welfare require that all utility lines and related facilities should be placed underground.

4. At all times AEWC resisted paying for placing the lines underground. It paid only when informed that it would not be permitted to occupy its facilities unless payment was made.

5. Edison computed the cost of undergrounding the electric lines by including a 28% income tax component.

6. The total cost of undergrounding the electric line is approximately $70,000 of which approximately $15,400 was the income tax component of the payment.

7. The undergrounding was done at the instigation of the city of Chino to provide a benefit to the public at large. AEWC benefits from the undergrounding only to the extent that it is a member of the public.

8. AEWC's contribution in aid of construction to Edison was made to obtain utility service for the benefit of AEWC. Without making the payment AEWC could not occupy its facilities and consequently would not obtain electric service. AEWC received a benefit from the payment of CIAC. The motivating factor for the transfer by AEWC was to comply with the Chino ordinance and building permits.

Conclusions of Law

1. It is the IRS, not this Commission, which will determine whether a transfer of property which is a contribution in aid of construction is or is not a taxable event.

2. There is no provision to indemnify Edison should it fail to collect the income tax component of the CIAC and should the IRS determine that the transaction is a taxable event.

3. The relief requested by complainant should be denied.

O R D E R

IT IS ORDERED that the relief requested by complainant is denied.

This order becomes effective 30 days from today.

Dated September 2, 1992, at San Francisco, California.

DANIEL Wm. FESSLER
President
JOHN B. OHANIAN
NORMAN D. SHUMWAY
Commissioners

Commissioner Patricia M. Eckert, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY

NEAL J. SHULMAN, Executive Director