Report of the Committee on Tax Developments

On August 13, 1981, the Economic Recovery Tax Act of 1981 ("ERTA") was signed into law. This statute contains a number of additions and modifications to the Internal Revenue Code, several of which are of particular significance for energy-related firms.

A. *Depreciation and Related Tax Normalization Provisions.*

The ERTA, in Section 201, establishes a new depreciation system for property which the taxpayer places in service after December 31, 1980 — the new system being termed the Accelerated Cost Recovery System ("ACRS"). The ACRS abandons the approach of prior law whereby depreciation deductions were related to the useful lives of assets in favor of allowing depreciation deductions computed by reference to predetermined periods (3, 5, 10 or 15 years) established for each asset class. These predetermined periods are generally substantially shorter than the recovery period that would have prevailed in the absence of the ACRS. The ACRS also prescribes an allowable method for computing accelerated depreciation deductions, and eliminates the salvage value limitation of prior law.

The ERTA also amends and broadens the prior rule regarding the treatment of such deductions in utility (including natural gas pipeline company) rates. Specifically, such utilities may take advantage of accelerated depreciation and the newly prescribed recovery periods only if they employ a normalization method of accounting with respect to timing differences resulting from the differences in depreciation methods and lives used for tax and book (*i.e.*, rate) purposes. (A similar requirement is prescribed for investment tax credits related to such assets.) If "flowthrough" rather than normalization is employed, the depreciation method and lives used for book purposes would also govern for tax purposes. Under a transitional rule, administrative agencies are given until January 1, 1983, to issue a rate order permitting normalization for any utility which, by the terms of a prior rate order, would otherwise be required to adopt flowthrough treatment of such timing differences.[1]

The foregoing normalization rules, as well a certain other restrictions (including, for example, provisions relating to the sale or lease of property designed to transfer tax benefits), apply to all "public utility" property. Public utility property consists of property employed in providing a utility service for which rates are prescribed or approved by a governmental body on the basis of the utility's cost of service. Under the Public Utility Regulatory Policies Act ("PURPA"), sales of electricity generated by means of qualifying cogeneration and small power production facilities are exempt from such regulation, and, therefore, such facilities would not constitute public utility property under the ERTA. If a recent court decision holding PURPA unconstitutional is affirmed

[1]On May 6, 1981, the Federal Energy Regulatory Commission ("FERC") issued Order No. 144 prescribing normalization of all book/tax timing differences not being normalized pursuant to prior Commission orders. This Order is the subject of an appeal filed in the United States Court of Appeals for the District of Columbia Circuit. *See Public Systems, et al. v. FERC*, No. 82-1183. It is presently not clear whether this generic rule will satisfy the rate order requirement of the transitional rule discussed above.

by the Supreme Court, however, these qualifying facilities would presumably become subject to treatment as public utility property.

B. *Investment Tax Credits and Energy Tax Credits.*

While not substantially broadening the availability of the investment and energy tax credits, the ERTA does prescribe certain new rules regarding the computation and recapture of these credits. In general, both the computation and recapture requirements established by the ERTA are tied to the recovery period specified for the property by the ACRS. In addition, the statute prescribes an "at risk" rule which will limit the amount of such credits for certain taxpayers. Under the new rule, individuals, Subchapter S corporations and certain closely held corporations can claim such credits only with respect to the amount of their investment which is actually at risk, thus excluding, for example, borrowed sums for which the taxpayer is not personally liable. Two exceptions to the at-risk rule are provided, however. First, subject to the requirement that the taxpayer have at risk at least 20 percent of the investment, the at-risk amount on which the credit is based may be increased, subject to certain limitations, to the extent of (1) funds loaned or guaranteed by the federal government or any state or local government or (2) funds loaned by a "qualified lender." A second exception relates to "amounts borrowed with respect to qualified energy property." Qualified energy property includes cogeneration facilities (as defined in the statute) as well as certain other categories of energy equipment. Subject to certain requirements, financing for such facilities, even if not within the first exception dicsussed above, will be deemed "at risk" for purposes of determining allowable credits.

C. *Safe Harbor Leases*

The ERTA significantly liberalizes existing rules governing the characterization of transactions as leases for federal income tax purposes. The new rules are designed to facilitate the transfer of tax credits and depreciation allowances by firms which, because of tax losses or for other reasons, are unable to take full advantage of such benefits. In order for a transaction to be recognized as a lease for tax purposes under the ERTA, only the following criteria need be met: the parties must elect to treat the lessor as the owner of the property; the lessor must generally be a corporation; the lessor must be at risk with respect to at least 10 percent of the property's adjusted basis; the lease term must satisfy certain requirements; and the leased property must generally be new section 38 property. If these criteria are met, the Internal Revenue Service cannot apply any other criterion in determining whether the transaction constitutes a lease for purposes determining eligibility to claim tax benefits associated with the leased property. These provisions effectively enable firms which have little or no taxable income to enter into sale-leaseback or similar arrangements and thereby transfer tax benefits associated with new investments to a profitable company which can use them.

If the lessee is a public utility, the property involved would normally be subject to the normalization requirements discussed above. Neither the Internal Revenue Service nor the FERC, however, has yet specified how such requirements will be applied to safe harbor leases.

D. Public Utility Dividend Reinvestment Plans.

In order to encourage reinvestment of earnings by public utilities, the ERTA provides that public utilities may establish a plan whereby earnings are retained by the company for reinvestment while dividends are made in the form of common stock rather than cash. When stock dividends are made pursuant to such a plan, the dividends (up to specified amounts) will not be immediately taxable (as under prior law), but, rather, would have a zero basis and be taxable when sold, generally at capital gains rates. In order to qualify under these provisions, at least 60 percent of the property acquired by the public utility (or the affiliated group of which it was a member) during the preceding ten-year period must have been "public utility" property.

E. Windfall Profit Tax Amendments.

The ERTA amends the Crude Oil Windfall Profit Tax Act of 1980 ("WPTA") in several respects. Under the WPTA, royalty owners were allowed a credit (or refund) of up to $1,000 against their windfall profit tax liability for their royalty oil produced during 1980. The ERTA allows $2,500 credit for such oil for 1981, while for 1982 and thereafter, the statute allows a limited credit based on the amount of the royalty oil produced.

The ERTA also exempts from windfall profit taxes, subject to certain restrictions, all stripper oil produced by independent producers, and reduces the windfall profit tax applicable to newly discovered oil. Finally, the statute cures a problem faced by certain producers; of natural gas from "tight formations." Under Section 107(d) of the Natural Gas Policy Act of 1978, in order to qualify for incentive tight formation gas prices established by the FERC, a producer must have filed, within a specified time period, an election to waive tax benefits extended to tight formation gas by the WPTA. A number or producers were unaware of this statutory deadline and thus were potentially barred from recovering incentive prices for their tight formation production. The ERTA removed this difficulty by providing that the Section 107(d) election requirement would not apply to tax benefits established for such gas in the WPTA.

Recently, a bill (H.R. 6056) containing technical amendments to the WPTA has been introduced in the House of Representatives. Among other things, the proposed amendments would remove the present uncertainty regarding application of the WPTA to natural gas condensate by making all such condensate taxable retroactively to the date of enactment of the WPTA. The technical amendments also delineate the treatment of cost recovery oil for holders of net profits interests.

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