Report of The Committee on Tax Developments

I. Introduction

This past year has seen a number of important decisions affecting the ratemaking treatment of the income taxes that electric utilities and natural gas companies pay. One of the most important was judicial affirmance, after a number of years of litigation, of the Federal Energy Regulatory Commission's ("Commission's") policy favoring comprehensive income tax normalization. Another was the Commission's decision applying the "stand alone" concept to determine the tax allowance for regulated companies that file consolidated income tax returns. During the year there were also several Internal Revenue Service rulings concerning the income tax liability of public utility companies. In addition, this report highlights several recent changes in the tax laws as they affect public utilities and oil and gas producers.

II. Court and Commission Decisions

A. Normalization vs. Flow-through Tax Accounting.

The District of Columbia Circuit's May 1983 decision in *Public Systems* v. *FERC,* 709 F.2d 73 (D.C. Cir. 1983), was an important one in the long-standing controversy between normalized and flow-through income tax accounting for electric utilities and gas pipelines. The Court affirmed Order Nos. 144 and 144-A,[1] which adopted comprehensive normalization of the timing differences between the recognition of expenses for income tax and ratemaking purposes.

The Court decision (referred to below as *"Public Systems II"*) resulted from a court remand several years before in a case having the same name, *Public Systems* v. *FERC,* 606 F.2d 973 (D.C. Cir. 1979) (*"Public Systems I"*), in which the Commission had also adopted comprehensive normalization. In the earlier case, the Court found the Commission's explanation of its actions inadequate and remanded the proceedings for further consideration. A central issue was the Commission's conclusion that normalization does not produce a permanent tax savings. The Court said the Commission's conclusion was not supported by the record, and criticized the Commission's "failure to explain the goals of its policy." *Id.* at 978-79, 981. The Court also said the Commission's orders had "provide[d] no indication of the impact on consumers or utilities of adopting" normalization. *Id.* at 980.

Public Systems II reflects a somewhat different approach. For example, in *Public Systems I* the Court had approached the tax savings versus deferral issue on an *aggregate* basis and concluded that in an expanding economy utilities would generally have a continuing "tax savings" due to accelerated depreciation. 606 F.2d at 981. *Public Systems II,* on the other hand, approached this question from the standpoint of *individual* timing difference transactions. 709 F.2d at 75-76. As the court explained:

[1] 15 FERC ¶ 61,133 (1981); 18 FERC ¶ 61,163 (1982).

> By definition, timing differences do not result in permanent differences in the ratemaking and tax books. Every difference that arises in one period will exactly reverse itself in one or more subsequent periods.

Id. at 76; *see also id.* at 81.[2] *Public Systems II* recognized that the Commission's policy stance on tax savings versus deferred has changed several times. *Id.* at 81-82. The Court concluded that the Commission's analysis of the tax savings versus deferral question was reasoned decisionmaking and deferred to the Commission's position that a permanent tax savings will not result from normalization. *Id.* at 82. In addition, the court ruled that the Commission had properly evaluated the financial impact — for both consumers and utilities — of normalization. *See* 709 F.2d at 82-83.[3]

Another court decision involving normalization is *Memphis Light, Gas and Water Division* v. *FERC,* 707 F.2d 565 (D.C. Cir. 1983). The issue was whether a pipeline's deferred tax account was excessive because accruals to the account had been based on higher tax rates which were no longer in effect.[4] Agreeing with the Commission, the Court rejected that argument. The Court explained that the pipeline's deferred tax account was actually *deficient* because of previous years of flow-through, and the net effect of past years' accruals at the higher-than-current tax rate was simply to shorten the period that the deficiency will continue. *Id.* at 571. The court said the Commission's decision to allow faster elimination of the deficiency was a "reasonable accommodation" of the change in the tax rate. *Id.* at 572.[5]

Closely related to the *Memphis* case is Opinion No. 189, *Delmarva Power and Light Co.,* 25 FERC ¶ 61,022 (1983).[6] In *Delmarva* it was also argued that the utility's deferred tax reserve was excessive due to the reduction in the corporate tax rate. The Commission disagreed. Relying on its earlier decision in *Virginia Electric Power Co.,* 15 FERC ¶ 61,052 (1981), the Commission said that in view of its "checkered history" concerning normalization versus flow-through tax accounting, there is "a presumption" that a company's deferred tax account is underfunded in view of the Commission's current full normalization policy. *See,* 25 FERC ¶ 61,022 at p. 61,120.

[2] *But see* Memphis Light, Gas and Water Division v. FERC, 707 F.2d 565, 567 (D.C. Cir. 1983):

> The deferral aspects of accelerated depreciation are theoretical because, given constantly expanding investments made by utilities and continuous inflation in the economy, a utility is able to avoid the "turn-around" point when taxes are supposed to become higher than under the usual straight-line method. Thus, the accelerated depreciation methods sanctioned by section 167 often result in large and permanent tax savings for a utility.

[3] Public Systems II also agreed with the Commission's decision that "price squeeze" issues in connection with normalization should be treated on a case-by-case basis. 709 F.2d at 83-84.

[4] The corporate income tax rate had changed from 53 percent to 48 percent and then to 46 percent.

[5] The final argument in Memphis was that due to the reduction in the tax rate, the "tax-on-tax" component of the pipeline's rates for prior years — which results from normalization — was excessive. The court rejected this argument. The court explained that for the previous years at issue the pipeline's tax bills were in fact based on the higher rates then in effect and "the Commission reasonably may decide not to reopen or readjust rates established for prior years." 707 F.2d at 573.

[6] *See also* Opinion No. 189-A, 25 FERC ¶ 61,343 (1983); Opinion No. 189-B, 26 FERC ¶ 61,027 (1984).

One additional court decision, *Farmers Union Central Exchange, Inc.* v. *FERC,* 734 F.2d 1486 (D.C. Cir. 1984), involves tax normalization in the context of oil pipeline regulation. *Farmers Union* reviewed the *Williams* decision, Opinion No. 154,[7] in which the Commission ruled that oil pipelines could decide for themselves whether to normalize or flow-through the timing differences resulting from accelerated depreciation. The Commission, however, also required a pipeline that chooses normalization to deduct its deferred tax account balance from rate base. On appeal, oil pipelines argued that this would eliminate the benefits of accelerated depreciation. The Court rejected that argument, explaining that "[r]egardless of whether an oil pipeline may include tax reserve accounts in its rate base, tax normalization accounting would permit it to benefit from accelerated depreciation without having to flow those benefits through to its customers." *Farmers Union,* 734 F.2d at 1530.[8]

Another variation of the flow-through versus normalization question was presented in Opinion Nos. 178 and 178-A, *Distrigas of Massachusetts Corp.,* 23 FERC ¶ 61,416 (1983) and 24 FERC ¶ 61,250 (1983). The issue was whether a pipeline's unfunded future tax liability (for future periods when tax and book timing differences would reverse) could be recovered through rates. The Commission affirmed the Administrative Law Judge's conclusion that because the pipeline "was [in the past] able to reduce its income tax liability as a result of tax vs. book timing differences and those savings were retained and not passed on to customers, then the customers are not liable for the increased tax liability when the timing differences reverse." *See "Initial Decision of the Administrative Law Judge,"* 18 FERC ¶ 63,036 at p. 65,112. That situation was distinguished from the case where the pipeline's customers had previously benefited from the pipeline's flow-through of the tax benefits of accelerated depreciation. *Id.; see also Natural Gas Pipeline Co.,* 13 FERC ¶ 61,266 (1980).

The Commission also agreed with the ALJ's conclusion that when the pipeline "used accelerated depreciation for tax purposes and did not flow through the effect of that method in its rates," the funds thus retained "constituted an effective replacement" for capital that otherwise would have been supplied by investors. *See* 18 FERC ¶ 63,036. The pipeline was required to increase its deferred tax account by the amount of the tax savings and make a corresponding reducton to rate base. In computing those parallel adjustments, the Commission concluded in Opinion No. 178 that the former 48 percent corporate tax rate should be used rather than the current 46 percent rate because the tax benefits in question were secured when the higher rate was in effect. *See* 23 FERC ¶ 61,416 at p. 61,916.

Opinion No. 178, *supra,* was relied on in Opinion Nos. 193 and 193-A, *Arizona Public Service Co.,* 25 FERC ¶¶ 61,092 and 61,393 (1983). The issue in *Arizona Public Service* was the appropriate ratemaking treatment of the company's proceeds from

[7]Williams Pipe Line Co., 21 FERC ¶ 61,260 (1982).

[8]On the other hand, Farmers Union criticized the Commission's rationale for normalization as inconsistent. Thus, while the Commission's Williams decision, Opinion No. 154, said the "essential reason" for normalization is to "facilitate[] the comparable earnings analysis" that is basic to the Commission's rate of return determination, 21 FERC at p. 61,656, the court said the Commission had downplayed comparable earnings analysis elsewhere in Opinion No. 154. *See* Farmers Union, 734 F.2d at 1530, n. 80. The court remanded the normalization question for a rearticulation of the Commission's reasoning.

the sale of tax depreciation and investment tax credits under the "safe harbor" provision of the Economic Recovery Tax Act of 1981 ("ERTA"). *See* Pub. L. No. 97-34 § 201, 95 Stat. 203, 214 (1981). The Commission ruled that the proceeds of the safe harbor transaction should be amortized as a reduction to the utility's tax expense over the service life of the generating unit that was the basis for the transaction. The major issue was whether the unamortized balance of those proceeds should be used to reduce rate base. Relying on Opinion No. 178, the Commission ruled that "remov[ing] the unamortized balance of the proceeds from rate base is consistent with our previous adherence to the principle that investors should earn a return only on the capital they contribute." 25 FERC ¶ 61,092 at p. 61,309.[9]

B. Consolidated Income Taxes.

The consolidated income tax issue has recently been revisited by the Commission in Opinion No. 173, *Columbia Gulf Transmission Co.,* 23 FERC ¶ 61,396 (1983) and Opinion No. 174, *Southern Natural Gas Co.,* 23 FERC ¶ 61,397 (1983).[10] This issue arises when a regulated utility and its affiliates (both utility and non-utility) file a consolidated federal income tax return. Use of a consolidated return can result in lower overall tax liability because it permits members of the group having net income to take advantage of the unused expense deductions of the group member or members that show a tax loss. The issue for ratemaking purposes is how to determine the portion of the consolidated income tax liability that should be allocated to the regulated company in determining the income tax component of its rates. *Columbia* and *Southern* are the most recent examples of the long history of litigation of the consolidated income tax issue before the Commission and its predecessor.[11]

The central issue in Opinions Nos. 173 and 174 is whether the regulated company's income tax allowance should reflect a *pro rata* share of the consolidated tax liability or be based on the "stand alone" method. Under the "stand alone" method the company's tax allowance is based on "the revenues and costs entering into the regulated cost of service without increase or decrease for tax gains or losses related to other activities." 23 FERC at p. 61,852.

The Commission's detailed opinion adopts the "stand alone" method. In reaching that decision the Commission emphasized that resolution of this issue requires it to match responsibility for expenses with entitlement to the income tax deduction benefits that the expenses represent. *Id.* at pp. 61,850-51. The Commission explained:

[9]Subsequent to the transaction at issue in Arizona Public Service, Congress made public utilities ineligible for safe harbor transactions. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, § 209, 96 Stat. 324, 442.

[10]*See* Notices of Denial of Rehearing, 24 FERC ¶¶ 61,258 and 61,259 (1983). Opinion No. 174 explicitly follows Opinion No. 173. Judicial review of Opinion No. 173 is pending *sub nom.* City of Charlottesville v. FERC, No. 83-2059 (D.C. Cir., filed October 6, 1983).

[11]This history is discussed in City of Charlottesville v. FERC, 661 F.2d 945, 947-49 (D.C. Cir. 1981). Charlottesville reviewed and remanded Opinion No. 47, 8 FERC ¶ 61,002 (1979) and Opinion No. 47-A, 9 FERC ¶ 61,355 (1979). Opinion No. 173, Columbia Gulf Transmission, is the Commission's decision following that remand.

> the proper way to allocate deductions is to match the deductions with the expenses included in the cost of service. Thus, when an expense is included in the cost of service, the corresponding tax deduction is also allocated to the ratepayers. In this way any tax reducing benefits, or savings, the company realizes *in providing the service* are recognized in calculating the tax allowance for the benefit of the ratepayers.

Id. at p. 61,851 (emphasis supplied). Opinion No. 173 adds that the corollary to these concepts

> is that when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that expense is not allocated to the ratepayers. To do otherwise would result in the tax savings the company realizes from expenses incurred in providing services to other groups and periods or for its own benefit being used to reduce rates for a particular group of ratepayers.

In other words, under the Commission's stand alone policy the precondition for reducing a regulated company's income tax allowance based on deductions shown in the consolidate return is a "causal link" between the regulated company and the expenses that underlie the additional deductions. *Id.*[12]

It should also be noted that the alterntive method for allocating the benefits of a consolidated return rejected in Opinion No. 173 would apportion those benefits to the regulated company based on its relative share of the taxable income of the companies filing the consolidated return. *Id.* at pp. 61,853-54. The Commission rejected this approach as inconsistent with the matching principle described above. *Id.* at p. 61,854.

The Commission Applies The Stand Alone Concept To Electric Utilities. The Commission has ruled that the reasoning of *Columbia Gulf* "applies with equal force to electric utilities as it does to gas pipelines." Opinion No. 163-A, *Potomac Edison Co.*, 23 FERC ¶ 61,398 (1983). The Commission had previously reserved this issue in the *Potomac Edison* proceeding, pending the outcome of *Columbia Gulf. See* Opinion No. 163, 23 FERC ¶ 61,106 at p. 61,257 (1983).

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[12]Under the facts of Columbia Gulf, the Commission found that in most, but not all, instances the companies having "excess" deductions within the group that filed the consolidated return had not incurred the related expenses for the benefit of ratepayers. Therefore, under the stand alone policy, the income tax allowance for the regulated companies should not reflect those deductions.

In reaching its decision, the Commission declined to readopt the method for apportioning the benefits of a consolidated return that was first announced in the Cities Service case, Opinion No. 396, 30 FPC 158, *reh. denied*, 30 FPC 676 (1963), *rev'd* Cities Service Gas Co. v. FPC, 337 F.2d 97 (10th Cir. 1964), and later approved in FPC v. United Gas Pipe Line Co., 386 U.S. 237 (1967). That method "(1) separate[d] the companies [filing the consolidated return] *** into regulated and unregulated groups; (2) determine[d] the net aggregate taxable income of each group; and (3) allocate[d] the consolidated tax liability between the groups and among the companies of each group on the basis of their respective taxable incomes." Columbia Gulf, 23 FERC ¶ 61,396 at p. 61,856. In Columbia Gulf the Commission decided not to readhere to this method because, among other reasons, it does not conform to the cost responsibility principles that underlie the Commission's stand alone policy. *See id.* at p. 61,857.

C. *Inconsistent Treatment Of Expenses By The IRS And FERC.*

Opinion Nos. 153 and 153-A, *Kansas-Nebraska Natural Gas Company, Inc.,* 21 FERC ¶ 61,118 and 22 FERC ¶ 61,252, preseanted an unusual set of facts where the IRS disallowed a portion of an expense deduction that FERC had allowed in cost of service. Specifically, as part of a settlement the IRS had disallowed as a deduction 25 percent of the mineral interest payments the pipeline made to the former owners of gas production properties that the pipeline had purchased (the IRS's reasons for doing so are not discussed in the Commission's opinions). The pipeline sought to recover the resulting additional tax liability through rates.

The pipeline's position was consistent with the "actual taxes paid" concept. *See generally City of Charlottesville* v. *FERC, supra,* 661 F.2d at 952, n. 38. But the Commission reasoned that "[a] legitimate expense for cost of service purposes [the Commission allowed recovery of the full amount of the mineral interest payments] should be considered as a legitimate deductible expense in calculating a company's cost of service tax component." 22 FERC ¶ 61,252 at p. 61,457. The Commission concluded that the inconsistent treatment by the IRS "has no effect on th[at] underlying principle." *Id.* In a footnote the Commission added that it might examine the propriety of the expense for cost of service purposes at a future time. *See id.* at p. 61,458, n. 1.

III. Internal Revenue Service Rulings

A. *Normalization And Other Tax Accounting Matters*

1. *Private Letter Ruling 8321150.* This ruling held that a state ratemaking agency's order that a public utility refund from its deferred tax reserve account amounts associated with the reduction of the federal corporate income tax rate from 48 percent to 46 percent would cause the utility to violate the IRS' normalization regulations. The state agency had ordered refunds, ruling that the amounts previously collected to cover the *current* tax liability associated with deferred tax revenue were too high because of the reduction in the corporate tax rate.[13] The IRS ruled that the agency's order would violate the IRS' normalization regulations if the refund results in an adjustment to either the tax expense used in establishing cost of service for ratemaking purposes or the reserve account for deferred taxes.

2. *Private Letter Ruling 8338071.* Prior to the enactment of ERTA, the gas distribution company requesting this ruling had used flow-through accounting. To qualify for ACRS (Accelerated Cost Recovery System) depreciation, ERTA required the utility to shift to normalized accounting. The utility requested its ratemaking

[13]Because deferred taxes are not deductible in determining current income, the taxpayer must recover revenues to cover deferred taxes as well as the current tax liability on that amount. This is the so-called "tax-on-tax" effect. *See* Memphis Light, Gas and Water Division v. FERC, *supra,* 707 F.2d at 572.

The agency had also ordered a refund of the difference between the deferred tax reserve necessary under the previous 48 percent rate and the current 46 percent rate. The letter ruling expressed no opinion on the first aspect of the agency's order (the taxpayer did not request a ruling); the question is being considered in an open regulation project.

agency's approval of that change. The agency approved but said the deferred tax reserve should be "based upon the company's historical experience in prior years, with certain adjustments excluding large deviations from the norm." This resulted in recalculating the deferred tax reserve at an effective rate below the 46 percent statutory rate. The IRS said this approach was improper because the deferred tax reserve is to be computed solely as a function of the difference between depreciation for tax and ratemaking purposes and the statutory tax rate. The ratemaking agency's proposal was, therefore, inconsistent with Section 167(l)(3)(A) of the Internal Revenue Code, 26 U.S.C. §§ 1, et seq., I.R.C. § 167(l)(3)(A), and Section 1.167(l)-1(h)(1)(iii) of the IRS regulations, Treas. Reg. § 1.167(l)-1(h)(1)(iii), 26 C.F.R. § 1.167(l)-1(h)(1)(iii) (1983).

3. *Private Letter Ruling 8348034.* This ruling involved a taxpayer's claim for an investment tax credit ("ITC") in connection with "qualified progress expenditures." Pursuant to ERTA, the utility obtained an order from its state ratemaking agency prohibiting future flow-through of ITCs. On the other hand, the state agency's practice prior to ERTA had been to order flow-through of qualified progress expenditure credits at the time they were projected to be earned. Nevertheless, in a pre-ERTA order the state agency allowed the utility to postpone flow-through of qualified progress expenditure credits in connection with two construction projects until the projects were placed in service (this was done to improve cash flow during construction). The IRS ruled that the postponed flow-through would not contradict ERTA's proscription of flow-through because this procedure was consistent with the pre-ERTA requirements of Section 46(f)(3) of the Tax Code, the corresponding IRS regulations and the transitional rule of ERTA Section 209(d)(3).

4. *Private Letter Ruling 8317082.* This ruling involved a small power producer who sought a determination as to whether its business of selling electricity is that of a "regulated public utility" within the meaning of various Internal Revenue Code provisions. If the small power producer were a public utility under those Code provisions, it would then be subject to the limitations imposed on utilities in computing the investment tax credit and depreciation. The IRS noted that the Code provisions that establish those limitations define a "public utility" as a firm whose rates are regulated based on its costs and an approved rate of return. The small power producer's retail rates are unregulated, however, and under the Public Utility Regulatory Policies Act of 1978 its wholesale rates are based on the costs the purchasing utility would have incurred to produce equivalent energy. Thus, the IRS ruled that the limitations that apply to utilities in computing the investment tax credit and depreciation do not apply to a small power producer.

B. Issues in Determining Taxable Income

1. *Private Letter Rulings 8341025 and 8346012.* These two letter rulings involved coal conversion costs. Two electric utilities asked the IRS to rule that the amounts they collected from ratepayers to fund the conversion of oil-fired generating units to coal generation were contributions in aid of construction under section 118 of the Internal Revenue Code, I.R.C. § 118, and not includable in the

utilities' gross income. While both rulings reach the same result, the facts of Ruling 8341025 are more instructive. The coal conversion funds would be (1) collected through a special surcharge, (2) accounted for separately from other receipts, (3) excluded from rate base and (4) spent within the second year following receipt (generally, these are requirements for qualifying as a contribution in aid of construction). However, relying on the legislative history of Section 118(b), *supra,* the IRS concluded that the statute was directed to contributions for *new or increased service.* These coal conversions were neither, and the IRS ruled that the related funds were not excluded from income under Section 118(b).

2. *Revenue Ruling 83-56.* This revenue ruling involved the tax-exempt status of industrial development bonds issued to finance the construction of a hydroelectric plant that will be owned by a regulated public utility. Interest on industrial development bonds is excludable from gross income if substantially all of the bond proceeds are used, among other matters, for the *local* furnishing of electric energy, which means a facility that provides service to the general population of no more than two contiguous counties or a city and one contiguous county. *See* I.R.C. § 103(b)(4)(E). Revenue Ruling 83-56 determined that a facility that is part of a system that serves or is capable of serving a larger geographic area (through an interconnected transmission system) does not qualify under Section 103(b)(4)(E). This ruling applied even though there was a reasonable expectation that the demand for electric energy in the otherwise qualifying local population center will exceed the hydroelectric plant's generating capacity.

3. *Private Letter Ruling 8351058.* This private letter ruling followed Revenue Ruling 83-56, *supra.* A small utility's service area was within two contiguous counties. The utility sought tax exempt financing for its undivided interest in a nuclear generating station. Applying Revenue Ruling 83-56, this letter ruling concluded that tax exempt financing was not available because the generating station is an integrated facility that will supply electricity to a number of utilities in a geographic area much larger than two counties.

4. *Private Letter Ruling 8338026.* The issue here was whether amounts provided to a utility by a customer (the customer was a state water resources agency) to construct electric power transmission facilities represented a loan or an advance payment for the utility's service. The IRS ruled that the arrangement in question was a loan. In the process, the IRS distinguished a number of related cases where the transaction was ruled an advance payment of income. This ruling emphasized that although there was no promissory note as such to support the loan, the written agreement between the utility and the public agency clearly obligated the utility to repay the funds to the agency monthly at a specified interest rate regardless of the quantity of electric service it purchased.

5. *Private Letter Ruling 8347007.* The taxpayer was an electric power generating company whose stock was owned by four electric utilities. The generating company was formed to provide power for defense-related federal government facilities. The initial 1951 contract between the generating company

and the government was modified several times in connection with changes in the government's power requirements. A 1972 modification required the government to pay the generating company, in addition to the contract rates for electricity, a surcharge to compensate the generating company and its shareholders for various matters that were not related directly to the cost of providing electricity under the contract.

Although the surcharge was paid to the generating company, the generating company immediately credited the surcharge to its shareholders. On that basis, the generating company argued that the surcharge was not includable in its own income. The IRS rejected that position, reasoning that even if the generating company had legally obligated itself to turn the surcharge over to shareholders, the surcharge is still includable in the generating company's gross income because it represents income from the sale of electricity.

IV. Legislative Developments

A. *The Nuclear Waste Policy Act*

The Nuclear Waste Policy Act was signed into law on January 7, 1983. Section 302 of the Act, 42 U.S.C. § 10222, authorizes the Secretary of Energy to contract with nuclear utilities for the acceptance of title, subsequent transportation, and disposal of high-level radioactive waste or spent nuclear fuel. The Act specifies a 1.0 mill per kilowatt-hour fee for this service, subject to future adjustment. 42 U.S.C. § 10222(a)(2) and (4). The Department of Energy ("DOE") has prescribed a standard contract for nuclear waste disposal services which utilities were required to sign by June 30, 1983 or by the date of the commencement of plant operations. 10 C.F.R. Part 961. Under the terms of the DOE standard contract, the fees applicable to spent nuclear fuel and high-level waste generated on or after April 7, 1983 are to be paid quarterly beginning on July 31, 1983, and the fees applicable to such waste generated before April 7, 1983 may be paid either in a lump sum or quarterly over a ten-year period. The fees collected by the Department are to be deposited in a Nuclear Waste Fund which will eventually be used to finance the development of a permanent repository. 42 U.S.C. 10222(c).

A question has arisen as to whether payments made to the Department under the Nuclear Waste Policy Act are currently deductible for tax purposes. Since DOE will not commence the transportation and disposal service until a permanent repository is developed, the payments are being made well in advance of the rendering of the service by DOE. As a result, the IRS is reportedly taking the position that such payments constitute the type of prepaid expense which may only be deducted at the time of performance of the services purchased. From the utility's pespective, however, it can be argued that this obligation satisfied the "all events" test for deductibility, that is, that all the events have occurred which fix the amount and the fact of the liability. *See Dixie Pine Products Co.* v. *Commissioner of Internal Revenue,* 320 U.S. 516 (1944).

B. *Nuclear Power Plant Decommissioning Expenses*

Section 91(c) of the Deficit Reduction Act of 1984, Pub. L. 98-369, adds a new Section 468A, "Special Rule For Nuclear Decommissioning Costs," to the Internal Revenue Code. This provision allows nuclear utilities, effective after the date of enactment, to deduct as a current expense payments to a "Nuclear Decommissioning Reserve Fund" ("Fund"). The amount of the deduction is the *lesser* of: (1) the nuclear power plant decommissioning costs allocable to the Fund and included in the utility's cost of service for the tax year; or (2) the "ruling amount" determined by the Treasury Department. The ruling amount is a level annual amount and essentially ratios down the amount deductible based on the nuclear plant's remaining useful life (*i.e.,* if two-thirds of the plant's useful life remains, then deductions are limited to two-thirds of estimated decommissioning costs).

The Fund required under Section 468A is a segregated trust fund. *See* H.R. Rep. No. 861, 98th Cong., 2nd Sess. 877-78 (1984). It is subject to the same restrictions that apply to a Black Lung Disability Trust Fund. *See* I.R.C. § 4951. Various studies indicate that despite the tax advantages, this method of external funding is more expensive for ratepayers than an internal reserve funding method without current deductibility. *See generally, Assuring the Availability of Funds for Decommissioning Nuclear Facilities,* NUREG-0584, U.S. Nuclear Regulatory Commission, Office of State Programs, Revision 3, March 1983, at 18-30. In this connection it should be noted that the Conference Report on the Deficit Reduction Act states that "it may be appropriate for the tax-writing committees to study further the tax treatment of decommissioning costs, and the merits of providing tax incentives for establishing decommissioning funds." *See* Conf. Rep. No. 861, *supra,* at 879.

C. *Changes in Tax Laws Affecting Oil and Gas Production*

The Deficit Reduction Act makes a number of changes that can affect oil and gas producers. A few of these are highlighted below.

1. *Windfall Profit Tax Rate on Newly Discovered Oil.* Under Section 25 of the new law, the windfall profit tax on newly discovered oil is 22.5 percent for 1984 through 1987, 20 percent for 1988, and 15 percent thereafter.

2. *Percentage Depletion on Secondary and Tertiary Production.* The allowance for percentage depletion on secondary and tertiary oil production expired at the end of 1983. Section 25 of the Deficit Reduction Act corrects the technical error leading to this termination and clarifies that percentage depletion will not be available after 1983 for proven properties transferred after 1974.

3 *Earnings and Profits.* Section 61 of the Deficit Reduction Act is intended to reduce the incidence of non-taxable shareholder dividends. The new law, therefore, expands the definition of earnings and profits in Section 312 of the Internal Revenue Code. For example, construction period interest, taxes and carrying

charges must be capitalized as part of the asset to which they relate, rather than being deducted in computing a corporation's earnings and profits. Similarly, intangible drilling costs and mineral exploration and development costs that are deductible in computing the corporation's taxable income, must be capitalized and amortized in determining the taxability of shareholder distributions.

4 *Changes in the At-Risk Rules.* Deductions for losses incurred in most business activities conducted by individuals, partners and closely held corporations have generally been limited to the amount that is economically at risk in the activity. Similar at-risk limits apply to the investment tax credit. Under Section 432 of the Deficit Reduction Act, the at-risk rules no longer apply to the activities of most closely held corporations that have at least three full-time nonowner employees engaged in the activity and incur out-of-pocket expenditures exceeding 15 percent of gross income from the activities.

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