Report of The Committee On Tax Developments

TAX DEVELOPMENTS which may affect the public utility industry fall into three major categories: (1) proposed legislation, including amendments to the Internal Revenue Code; (2) federal and state court cases and administrative agency decisions dealing with tax matters; and (3) IRS rulings and changes in regulations.

1. Legislative Outlook

Congress has not yet mapped out its income tax plans for 1980. The principal unresolved issue before it is how to use the tax system to increase national income. Capital formation remains in the forefront as a tax policy concept. This would be accomplished principally through depreciation allowances over a shorter period, an unlimited carryover period for unused investment credits or, perhaps, a refundable investment tax credit. Under the latter proposal, investment tax credits which could not be utilized in the year in which they were generated would become immediately refundable to the taxpayer which generated the credits. One of the appealing features of a refundable investment credit would be the simplification of leasing requirements currently prescribed under the Internal Revenue Code. This is one of the most complex areas in the tax law right now. Instead of purchasing outright, many utilities lease assets from a leasing company having a tax liability, with the investment credit passed on generally in lower rents. Under leasing arrangements a plethora of tax shelters have developed that would be undercut by refundability of tax credits.

The Value Added Tax is unpopular at the present time because of its inflationary impact. It is not in the picture for the near term.

It has been suggested that the tax package most likely to pass in 1980 will include the traditional tax cut of approximately $3 of personal taxes for $1 of business taxes. An alternative to a tax cut could be a roll-back of the $15 billion increase in Social Security taxes scheduled for January 1, 1981.

In summary, it would appear at this point that business in general, including utilities, should receive some further income tax relief during 1980. Although the "Crude Oil Windfall Profit Tax Act of 1980" contains some additional business energy tax incentives, the bill does not offer substantial tax benefits to utilities.

2. Federal and State Court and Administrative Agency Decisions

Status of Liberalized Depreciation and Investment Credit Issue In California Rate Case

Prior reports of this Committee have followed developments relating to rulings of the Internal Revenue Service issued to Pacific Telephone and Telegraph Company and General Telephone Company holding that these corporations will be ineligible to take accelerated depreciation and investment tax credits on public utility property under a decision of the California

Public Utilities Commission requiring flow-through of tax reductions pursuant to a formula devised by a Commission.

On February 13, 1980, the California commission ordered Pacific Telephone to refund $381 million to certain customers, covering the period 1974 through the date of the order. Pacific Telephone will be entitled to charge normalized rates in the future, subject to refund, until the substantive tax matter is finally decided.

The company recently paid a $117 million tax deficiency with interest to the IRS. The deficiency resulted from its loss of accelerated depreciation and investment credits due to the original flow-through decision of the California commission. Pacific Telephone will sue for a refund but has not yet chosen a forum, either the United States Court of Claims or a federal district court.

Indiana Court Of Appeals Holds That Utility's Cost Of Service Should Include Only Actual Taxes Paid

Reversing the Public Service Commission of Indiana, Indiana's Court of Appeals has held that a utility's cost of service should include the actual amount of taxes paid when the utility files a consolidated federal income tax return with other corporations. *Citizens Energy Coalition, Inc. v. Indiana & Michigan Electric Company,* 396 N.E.2d 441 (1979). Neither the electric utility involved nor its parent corporation incurred any federal income tax liability whatsoever in the test year, 1976. In fact, the utility's principal witness testified that he could not estimate when in the foreseeable future federal income taxes would be incurred. The court followed its earlier decision in *City of Muncie v. Public Service Commission of Indiana,* 378 N.E.2d 896 (1978), where it held that the tax expense of the utility should be based on the effective federal income tax rate. The case involved a water utility which participated in a consolidated federal income tax return with its parent holding company and approximately 50 other subsidiary water utilities.

FERC Response to Public Systems Case

The Court of Appeals for the District of Columbia Circuit remanded to the FERC Order 530-B which prescribed normalization treatment for deferred taxes. *Public Systems v. Fed. Energy Reg. Commission,* 606 F.2d 973 (D.C. Cir. 1979). In response to the Court's decision, the FERC issued interim procedures dealing with the issue of tax normalization. The interim procedures state that Order 530-B will remain in effect pending the FERC's ultimate decision in the matter. During rate proceedings before the FERC, public utilities will be permitted, although not required, to submit evidence demonstrating that a tax deferral rather than a tax savings would occur under tax normalization. If a utility presents evidence on the issue, Intervenors or the Staff will be allowed to submit evidence in support of or in opposition to the request.

Federal Energy Regulatory Commission Reaffirms Its Position On The Consolidated Effective Tax Rate Issue

The Federal Energy Regulatory Commission, in its opinion on rehearing in the case of *Columbia Gas Transmission Corporation,* Opinion No. 47-A (issued December 20, 1979), has reaffirmed its position that, in calculating income taxes for cost of service purposes, pipelines should be treated on a "stand alone basis" even though the pipeline company is included in a consolidated tax return. The FERC reasoned that a contrary decision on the consolidated effective tax rate issue would provide a disincentive to exploration for oil and gas resources. The Commission also noted that the pipeline customers would not be charged any more than they would have been had a consolidated return not been filed. On February 12, 1980, the City of Charlottesville, Virginia, the only intervenor in the case, filed an appeal with the U.S. Court of Appeals for the District of Columbia.

FERC Corrects Technical Errors in Regulations And Forms Regarding Account 670

The FERC has issued an Order (FERC Order No. 62) amending the title of Account 670 of the Uniform System of Accounts for Pipeline Companies, 49 C.F.R. Part 1204 (1978). Specifically, the title of Account 670, "Federal Income taxes on income from continuing operations," has been corrected to read, "Income taxes on income from continuing operations." This account should include all income taxes (federal, state, local, and foreign) on income from continuing operations, not merely federal taxes. To the extent that any oil pipeline company required to file annual reports with FERC did not correctly report state or other income taxes on continuing operations for the three preceding reporting years, the company must disclose the amount of the prior accounting error in the space for notes and remarks provided in its 1979 Annual Report Form P, Schedule 300-A, in order to assure financial data comparability.

Natural Gas Pipeline May Depreciate Line Pack

In a case of first impression, a trial judge of the United States Court of Claims has held that for federal income tax purposes, the cost of line pack in a natural gas pipeline system constitutes a capital expenditure which is depreciable over the useful life of the system. *Transwestern Pipeline Company v. United States,* 79-2 U.S.T.C. ¶ 9670, 44 AFTR2d 79-5964 (Ct. Cl. 1979). In so holding, the trial judge rejected the position long taken by the Internal Revenue Service in Revenue Ruling 68-548, 1968-2 C.B. 199, *amplified in* Rev. Rul. 78-352, 1978-2 C.B. 168, that the cost of line pack is a nondepreciable inventory expense.

The trial judge based his decision on two findings: first, that line pack constitutes property used in trade or business within the meaning of section 167 of the Internal Revenue Code and, second, that line pack is not property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business under section 1231(b)(1)(B). Whether the trial judge's reasoning will be upheld on appeal, however, is uncertain in light of the recent decision of the United States Supreme Court in *Thor Power Tool Company v. Commissioner,* 439 U.S. 522 (1979), granting broad discretion to the Commissioner in determining whether a taxpayer's method of accounting clearly reflects income.

Utility Trucks With Pintle Hooks May Be Truck-Trailer Combinations

Under the federal highway use tax, trucks classified as single units are taxed at a significantly lower rate than trucks classified as truck-trailer combinations. A truck is classified as a truck-trailer combination if it is "customarily used in combination with" trailers or semitrailers. The Internal Revenue Service has repeatedly taken the position that utility trucks equipped with pintle hooks are capable of being used in connection with trailers and semi-trailers and are therefore classifiable as truck-trailer combinations. The Service adheres to this position in spite of the fact that most utility trucks are not used to pull trailers or semi-trailers.

In the first case to address this issue, *Pacific Gas & Electric Company v. United States,* The District Court for the Northern District of California in an unpublished opinion has held that the Service did not abuse its discretion in classifying as truck-trailer combinations utility trucks equipped with pintle hooks. At the time this report was prepared, the plaintiff in the refund action, Pacific Gas & Electric Company, had not yet decided whether to appeal the decision to the Court of Appeals for the Ninth Circuit.

Depreciation Deduction Denied for Equipment Used to Self-Construct Transmission Facility

Following the Supreme Court's decision in *Commissioner of Internal Revenue v. Idaho Power Company,* 74-2 U.S.T.C. ¶ 9521, 418 U.S. 1 (1974), a U.S. district court has recently held that an electric utility could not claim accelerated depreciation on equipment used in self-constructing a transmission facility. *Pacific Power & Light Company v. United States*, 79-2 U.S.T.C. ¶ 9435 (D. Ore. 1979). Rather, the utility must capitalize such expenses into the cost of the longer-lived capital improvement.

Accounting Treatment for Electric Line Acquisition

In *The Montana Power Company v. FERC* (U.S.C.A.—9th Cir., June 22, 1979), the Court considered whether FERC may prevent an electric utility from including in its rate base for accounting purposes the total cost of acquiring an electric transmission line from a railroad. The Commission order permitted Montana Power to include in its rate base account only that portion of the purchase price that represented the depreciated original cost of the line to the railroad that had built it. Also the difference between the acquisition cost and depreciated original cost was ordered placed in a non-rate base account to be amortized to operating expense. The Court upheld the decision of the Commission in a 2 to 1 decision.

3. IRS Rulings and Changes in Regulations

Full Year's Depreciation Allowable for Taxpayer Adopting Modified Half-Year Convention

In Revenue Ruling 79-203, 1979-27 I.R.B. 7, the Internal Revenue Service has ruled that a public utility company that adopted the modified half-year convention under Regulations section 1.167(a)-11 and placed an electrical generating unit in service during the first half of its taxable year was entitled to a full year's depreciation deduction.

Gas Utility Trunk Pipelines Are Public Utility Property

The Internal Revenue Service has held in Revenue Ruling 79-281, 1979-39 I.R.B. 7, that gas utility trunk pipelines, owned by a regulated public utility operating in a metropolitan area, that deliver gas from city gate stations to other points within the utility's system are public utility property within the meaning of section 46(c)(3)(B) of the Internal Revenue Code. Accordingly, the pipelines are classified under asset guideline class 49.24 of the Class Life Asset Depreciation Range System (CLADR).

The Service further ruled that a liquified natural gas (LNG) facility placed in service in 1974 is not classifiable under the CLADR System since Revenue Procedure 76-27, 1976-2 C.B. 644 permits the use of the CLADR System only for LNG plants first placed in service during taxable years beginning on or after January 1, 1975.

Depreciation Deductions And Investment Tax Credit For Pollution Control Equipment

In Letter Ruling 7950049, the Internal Revenue Service has dealt once more with depreciation deductions and the investment tax credit for certain pollution control facilities installed on an electrical generating unit owned by a public utility company.

Under an agreement between the utility and another corporation (a non-utility), the other corporation was to be responsible for all costs associated with the acquisition, construction, and installation of the pollution control facilities, referred to as "scrubbers," together with all the expenses of operating and maintaining the scrubbers. Legal title to the scrubbers was to remain in the other corporation. The utility was to license the other corporation to construct and operate the scrubbers. The utility, on behalf of the other corporation, was to design and engineer the scrubbers, sub-contract for (or itself undertake) the construction and installation thereof, perform all supervisory functions, and obtain necessary governmental permits and approvals. The utility was to make disbursements on behalf of the other corporation in connection with the costs of design, construction, and installation, and installation of the scrubbers. The utility on behalf of the other corporation was to operate the scrubbers and maintain them in such condition as might be required by governmental authorities. Except as might be required by law, regulation, or permit, it was anticipated that the scrubbers would be dismantled and removed by the other corporation at the end of fifteen years. If the regulatory agencies did not permit removal of the scrubbers, it was the other corporation's intention to sell the scrubbers to the utility company at the end of the agreement for an arm's length price.

Under these facts, the Service held that: (1) the other corporation could depreciate all depreciable property comprising the scrubbers pursuant to section 167 of the Code; (2) the other corporation could elect to amortize over a 60-month period the applicable basis for the scrubbers, provided the certification requirements contained in section 169(d) of the Code were met; (3) the other corporation would be entitled to the investment tax credit with respect to that portion of the scrubbers that constituted section 38 property; (4) the other corporation would be entitled to deductions under section 162(a) of the Code for its expenses in operating the scrubbers; (5) the public utility would not incur taxable income in connection with the construction and installation of the scrubbers on its premises by the other corporation, nor would the utility incur taxable income with respect to payments received from the other corporation attributable to construction activities where such payments did not exceed the other corporation's expenditures attributable to such construction; (6) the utility would not be entitled to deductions under section 162 for expenditures which it made for the operation and maintenance of the scrubbers to the extent that it had a right of reimbursement from the other corporation with respect to those expenditures; (7) the utility would not realize income to the extent that the reimbursements received from the other corporation did not exceed the aforementioned expenditures made or to be made for the other corporation by the utility; (8) should the other corporation fail to reimburse the utility for these expenditures, an ordinary deduction would be allowed to the utility pursuant to section 166; and (9) in the event that the expense incurred in the operation and maintenance of the scrubbers exceeded an amount specified in the agreement between the parties, whereupon the utility became solely liable for such excess expenses, such excess expenses would be deductible by the utility under section 162.

Untimely Election Prevents Flow-Through Of Investment Tax Credit

The Internal Revenue Service has ruled that a public utility cannot avail itself of the special rule for ratable flow-through of investment credit under section 46(f)(2) of the Internal Revenue Code by filing a late election. In Letter Ruling 7948109, the Service rejected a natural gas public utility's request for a ruling that a late election could be made under section 46(f)(2) to enable the utility to comply with a State public service commission order directing privately owned utilities to inform the Service that the commission would follow the special rule for ratable flow-through provided for in section 105(a)(2) of the Revenue Act of 1971, now section 46(f)(2).

Deduction of Research Expenditures by Joint Tenants

Where several public utility companies are joint tenants in the construction of a generating plant, the Internal Revenue Service has ruled in three substantially similar private letter rulings (Docs. 7926088, 7930028 and 7930061) that each utility may deduct its respective percentage of allowable research and experimental expenditures notwithstanding the fact that the tenants elected to be excluded, for tax purposes, from the partnership provisions of subchapter K, Chapter 1, Subtitle A of the Internal Revenue Code.

Flammability Testing Constitutes an Exempt Activity Described in Section 501(c)(3) of the Internal Revenue Code.

In a private letter ruling (Doc. 7930005), the Internal Revenue Service ruled that a corporation which is exempt under section 501(c)(3) of the Internal Revenue Code (Code) does not recognize unrelated business taxable income under section 511 of the Code arising from its activities in the area of fire technology. On the other hand, the corporation is subject to tax under section 511 of the Code for amounts received for its examinations of nuclear reactor power plants.

Purchased Electric Power—Currently Deductible or Capitalized and Deducted over Contract Term?

In a private letter ruling (Doc. 7927013) the Internal Revenue Service has ruled that a public utility is not prevented from currently deducting its cost of purchasing electric power where the amount of the charges will be reduced after 25 years. As part of a plan for the construction of an electric power plant, a regulated public utility contracted with another utility to purchase electricity over a 25-year period. The purchase price of the electricity equalled the second utility's debt service costs on the electric facility. The Service held that the purchasing utility's payments for purchased electric power are currently deductible. Such payments did not represent expenditures which had to be capitalized over the term of the power purchase contract.

Only Certain Components Of A Nuclear Electrical Generating Plant Qualify For Investment Tax Credit

In a detailed technical advice memorandum, Letter Ruling 8002002 supplemented by Letter Ruling 8002004, the Internal Revenue Service has identified those major components of a nuclear electrical generating plant which constitute section 38 property and, as such, qualify for the investment tax credit. The Service divided the component assets into three groups: site preparation and land improvements; radiation and thermal pollution control systems; and other structures. The Service further divided the second group of assets into three subgroups based on the type of waste by-products: gaseous; liquid; or solid. Within each of the three groups, the Service found that some properties qualified for both depreciation and investment credit, others for depreciation but not for investment credit and, finally, others for neither depreciation nor investment credit.

Group Term Life Insurance Premiums For Utility Company Construction Workers Held Currently Deductible

In a technical advice memorandum (LTR 7944015), the Internal Revenue Service has considered whether a regulated gas and electric utility could deduct the premiums that it paid for group term life insurance on employees engaged in the construction of facilities which the utility used in its business. Following I.T. 3408, 1940-2 C.B. 178, the Service held that the premiums were currently deductible under Code section 162. The Service also noted, however, that it is presently reconsidering the decision in I.T. 3408.

IRS Rules That Security Deposits Are Income

In two technical advice memoranda (LTR 7952032 and LTR 7952037), the Internal Revenue Service has held that customer security deposits received by utility companies are advance payments covered by Situation 2 of Revenue Ruling 72-519, 1972-2 C.B. 32, and are therefore includable in income in the year received.

IRS Modifies Guidelines for Advance Rulings on Leveraged Lease Transactions

In Revenue Procedure 79-48, 1979-39 I.R.B. 27, the Internal Revenue Service modified several of the prerequisites for obtaining advance rulings for leveraged lease transactions under Revenue Procedure 75-21, 1975-1 C.B. 715.

Under Revenue Procedure 75-21, the lessee was prohibited from furnishing any of the cost of the leased property, and any improvements that the lessee made had to be readily severable from the property. In Revenue Procedure 79-48, the Service explains that it will not treat as "improvements" property which could itself be separately leased in a transaction eligible for an advance ruling under Revenue Procedure 75-21.

Furthermore, Revenue Procedure 79-48 permits a lessee to make nonseverable improvements to the leased property provided certain conditions are met. First, such improvement must not be required in order to complete the property for its intended use. Secondly, the furnishing of the cost of the nonseverable improvement must not constitute an equity investment by the lessee. Finally, the nonseverable improvement must either be furnished in order to comply with certain health, safety, or environmental standards, or must not substantially increase the productivity or capacity of the property or modify the leased property for materially different use. The Service will consider an increase in productivity or capacity substantial only if the increase is more than 25 percent.

Revenue Procedure 79-48 concludes by providing that a nonseverable improvement that is not required by the terms of the lease will not be regarded as constituting rent. Therefore, the lessee will be allowed the deduction for amortization or depreciation and the investment credit with respect to the improvement, if otherwise available under the Internal Revenue Code. These revised guidelines are favorable from the standpoint of utilities.

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