

REPORT OF THE COMMITTEE ON TAX DEVELOPMENTS

This report covers tax developments during calendar year 1980 which may affect or be of interest to natural gas pipelines, gas and electric utilities, and oil pipelines. For organizational purposes, the reported developments have been divided into three categories: (1) legislation, including adopted and proposed bills; (2) federal and state court cases and administrative agency decisions dealing with tax matters; and (3) IRS rulings and changes in regulations.

I. LEGISLATION

A. Adopted in Last Session of Congress

Although 1980 was not a year in which Congress enacted major changes in the tax laws, a number of measures were passed which affect utilities in general. The Technical Corrections Act of 1979, approved by President Carter on April 1, 1980, provided, among other things, for the clarification of certain provisions of the Revenue Act of 1978 relating to the normalization of investment tax credits for public utility property. The law is now clear that the normalization rules do not apply to public utility property placed in service before 1971.

The Technical Corrections Act also provides that the generally applicable limitation for investment credits on pollution control equipment which is both financed by tax-exempt industrial development bonds and is subject to five-year amortization will not apply for purposes of the energy tax credit. Thus, pollution control equipment which is energy property and is financed by industrial development bonds will receive an energy credit of five percent, instead of the 2.5 percent credit which was the unintended result under 1978 legislation instituting the energy tax credit.

A bill which Congress passed during its post-election session, and which President Carter signed in late December, changed some of the rules that apply to mutual or cooperative electric companies. One such change relates to the Internal Revenue Code requirement (Section 501 (c)(12)) that at least 85 percent of a cooperative's income consist of amounts collected from members for the sole purpose of meeting losses and expenses. The bill provides that income from pole rentals now will be excluded in applying the 85 percent test to an electric cooperative. In addition, income from pole rentals will not constitute unrelated trade or business taxable income.

The Comprehensive Environmental Response, Compensation, and Liability Act of 1980, which was enacted in the latter part of the year, imposes a tax on feedstocks used in the manufacture of chemicals. The tax revenues will be used to finance cleanup and containment of hazardous waste. Under the tax provisions, utilities importing crude oil or other petroleum products will be required to pay .79 cents for each barrel of these substances.

Congress has also added a new section to the Internal Revenue Code which will allow a business firm to amortize business startup expenses over a period of 60 months or more. The expenses which may be amortized are those which (1) are paid or incurred in exploring the possibility of setting up or acquiring an active

business, or in actually setting up the business, and (2) would be allowable as a current deduction if they were incurred with respect to the expansion of an existing business of the type that the taxpayer has started.

A number of provisions dealing with tax credit employee stock ownership plans (commonly referred to as "TRASOP's") were enacted in 1980. A summary of some of the more significant provisions follows.

The Technical Corrections Act added a provision to the Internal Revenue Code that allows the Treasury to issue regulations providing that transfers of stock to a TRASOP may be made later than the normal deadline for such transfers, if the amount of any credit, carryover or carryback for any taxable year is greater than the amount shown on the return, and if this excess is attributable to matching employee contributions made after the close of the taxable year.

The Technical Corrections Act also makes clear that no gain or loss will be recognized by a corporation on a required transfer of employer securities to a TRASOP.

Legislation enacted late in 1980 changed the rules on the use of parent corporation stock by a subsidiary corporation in an affiliated group for contributions to a TRASOP of the subsidiary. Under the revised rules, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute securities of the parent corporation to the plan. Furthermore, stock of the parent may be contributed by 80-percent-owned lower-tier subsidiaries in the chain of corporations.

Recently enacted legislation also provides that the value of employer securities which are listed on a national exchange and which are contributed to a TRASOP will be the average of the closing prices of the securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan. Previously, the value was determined by the average of the closing prices for the 20 days preceding the due date for filing the employer's tax return for the year in question.

A final change in the deferred compensation area in 1980 was an amendment to the provisions on "eligible State deferred compensation plans" (Internal Revenue Code section 457). The definition of "rural electric cooperative" (the employees of which may participate in one of these deferred compensation plans in the same manner as if the plan were a plan of a State) has been revised to include certain rural electric cooperatives in the Tennessee Valley Authority and certain national and state associations of rural electric cooperatives.

B. Proposed Legislation

A number of legislative proposals which were not adopted during the 96th Congress are likely prospects for revival in 1981. Brief summaries of some of these proposals follow.

1. Tax Deferred Dividend Reinvestment

One item of proposed legislation which has been introduced in the 97th Congress (H.R. 654 and S. 141), and which will be of interest to many utility and energy companies, is the bill on tax-deferred dividend reinvestment. Under this bill, a shareholder would not pay a federal income tax currently, as he does under

present law, on corporate dividends which are reinvested in his company's stock under a qualified dividend reinvestment plan. It has been estimated that, if this proposal is adopted, reinvestment plans for new issue stock could provide about half of the common stock capital requirements of the utilities which have dividend reinvestment plans. With the creation of incentives for capital formation high on the Reagan administration's economic agenda, it may be expected that these bills will be given serious consideration in 1981.

2. California Normalization Relief

The House of Representatives approved in 1980 a bill, H.R. 6806, which would have provided relief to General Telephone Company of California, Pacific Telephone and Telegraph Company, and Southern California Gas Company. Those companies had been required by the California Public Utilities Commission to flow through to consumers the benefits of accelerated depreciation and investment tax credits in a manner not in accordance with the normalization rules contained in Internal Revenue Code sections 167(1) and 46(f). If it had been enacted into law, the bill would, in effect, have forgiven past sins of the California commission and allowed a tax refund to the utilities in amounts exceeding \$100 million. The bill also would have relieved these utilities of liability for tax deficiencies in the amount of \$1.6 billion. For periods beginning after March 1, 1980, however, the California utilities would have been required to adhere to the requirements of Code sections 167(1) and 46(f) in order to obtain the advantages of accelerated depreciation and investment tax credits.

Bills similar to H.R. 6806 were introduced in the House early in the 97th Congress.

3. Proposal for a Single Federal Court of Tax Appeals

A bill was introduced in the 96th Congress which would have created an appellate court to hear appeals in federal tax cases. Senator Kennedy's bill, S. 1691, would have created an eleven-member court. One circuit judge from each of the eleven federal judicial circuits would have been assigned to the new court, which would have had exclusive jurisdiction over any civil tax appeal from a district court or the United States Tax Court. The new court would have held at least one session per year in each of the circuits, and would have heard appeals in the judicial circuit where the taxpayer was domiciled (if the taxpayer was an individual) or in the circuit where a corporate taxpayer had its principal place of business. The decisions of the new court would have been subject to review by the United States Supreme Court.

4. Coal Utilization Incentives Act of 1980

On October 1, 1980, H.R. 8269 was introduced in the House of Representatives. The bill, entitled the Coal Utilization Incentives Act of 1980, was intended to amend the Clean Air Act and the Internal Revenue Code in order to provide for the use of coal in lieu of imported energy. As introduced, the bill would have amended the Internal Revenue Code to: (1) add a new section 194 to the Code to permit "coal utilization property" to be amortized over a 36-month period; (2) allow coal utilization property owned by a public utility to qualify for the energy

tax credits provided by the Energy Tax Act of 1978 and the Crude Oil Windfall Profit Tax Act of 1980; and (3) insure that coal utilization property eligible for 36-month amortization under the new section 194 would be eligible for the full investment tax credit in the same manner as pollution control equipment under present law.

5. The Industrial Energy Efficiency and Fuel Conversion Tax Incentive Act of 1980

The Industrial Energy Efficiency and Fuel Conversion Tax Incentive Act of 1980, introduced in the Senate (S. 3006), proposed to increase the energy investment credit to 20 percent for alternative energy property (except geothermal and ocean thermal property), specially defined energy property, and recycling equipment as defined in section 48(1) of the Code. The bill also would have created a new category of investment property, called "Qualified Industrial Energy Property" (QIEP), which would be eligible for a 20 percent investment credit.

II. FEDERAL AND STATE COURT AND ADMINISTRATIVE AGENCY DECISIONS

A. FERC Issues Proposed Rule on Tax Normalization

Prior reports of this committee have followed developments at the Federal Energy Regulatory Commission in response to the D.C. Circuit's remand of the Federal Power Commission's general tax normalization order (Order No. 530-B) in *Public Systems v. FERC*, 606 F.2d 973 (D.C. Cir. 1979). On March 31, 1980, the Commission issued a proposed rule (Docket No. RM80-42) which would permit electric utilities and natural gas pipelines to utilize normalization for all transactions (with certain exceptions described below) that create timing differences in the recognition of expenses or revenues for ratemaking (or "book") purposes and for income tax purposes. The rule would require that a company electing normalization for any of the subject transactions must normalize the tax effects of all other timing difference transactions. Once the tax normalization election has been made, it is applicable to all future rate filings unless the Commission allows otherwise.

The proposal is for a ratemaking rather than an accounting rule; thus, those provisions of Order No. 530 implementing normalization for accounting purposes would remain unchanged.

In describing the scope of its proposed rule, the Commission made clear that it was not reevaluating the accounting or ratemaking treatment of those timing difference transactions not addressed in Order No. 530 and its progeny. Those transactions, for which normalization has been prescribed in other FPC and FERC proceedings and, where appealed, upheld on judicial review, include:

(1) differences that result from the use of accelerated depreciation and Class Life Asset Depreciation Range (ADR) tax provisions of the Internal Revenue Code of 1954;

(2) differences that result from the use of accelerated amortization provisions on certified defense and pollution control facilities;

(3) differences that result from recognition of extraordinary property losses as a current expense for income tax purposes but as a deferred and amortized expense for ratemaking purposes;

(4) differences that arise from recognition of research, development, and demonstration expenditures as a current expense for income tax purposes but as a deferred and amortized expense for ratemaking purposes;

(5) differences that result from different reporting for income tax purposes and ratemaking purposes of deferred gains or losses from disposition of utility plant;

(6) differences that result from the use of the Asset Guideline Class "Repair Allowance" provision of the Internal Revenue Code of 1954; and

(7) differences that result from recognition of purchased gas costs as a current expense for income tax purposes but as a deferred expense for book purposes.

The FERC has invited both initial and reply comments from persons interested in the proposed rule. As of February 15, 1981, the Commission had taken no final action on the proposal.

B. Tax Court Holds Customer Deposits Are Not Taxable Income

Like most other jurisdictions, the State of Florida allows utilities subject to its regulation to require cash deposits to guarantee payment of bills. Under the rules of the Florida Public Service Commission, a utility may credit the deposit against a customer's final account upon termination of service and return any balance to the customer. In addition, the FPSC requires all electric and gas public utilities to pay a minimum of four percent interest on customer deposits and account for the deposits as current liabilities. In addition to these restrictions, Florida law provides for escheat to the State of unclaimed deposits which cannot be refunded to utility customers within a certain time after termination of service. Florida law does not require that deposits be kept separate from other utility company funds.

Notwithstanding these restrictions on a utility's use of security deposits, the Internal Revenue Service required City Gas Company of Florida and two of its subsidiaries to include such deposits in income in the year of receipt. However, in *City Gas Company of Florida v. Commissioner of Internal Revenue*, 74 T.C.—No. 26 (CCH) (May 27, 1980), the Tax Court held that such deposits need not be included in income. Under all the facts and circumstances, the court found that City Gas had neither a present right to nor unrestricted control over the deposits. Although the company had temporary use of customer deposits from the time of receipt, the court determined that the deposits were not advance payments for services but, instead, were security to assure that customers would pay all their bills upon termination of service. Other factors which the court considered significant were (1) that City Gas treated the deposits as liabilities, and (2) that it could discharge these liabilities only by applying the deposited amounts against unpaid bills or by refunding them to customers.

In reaching its decision, the Tax Court distinguished a line of cases relied upon by the Internal Revenue Service which hold that amounts received by a lessor as "security deposits" are advance rentals rather than security deposits and are thus taxable in the year of receipt. Contrary to that line of cases, said the court, the full amount of a deposit received by City Gas was either unconditionally subject to refund or subject to escheat to the State of Florida. Furthermore, although the total deposit might be applied against amounts owed to the company upon service termination, the taxpayer's right to any part of the deposit was not fixed and could not be determined when the customer made the deposit.

Unlike a tenant under a lease, the court found that a gas customer does not contract for services for any stated period and can terminate service at any time. Thus, City Gas became entitled to apply all or part of a deposit only if a customer otherwise failed to pay all charges due at termination.

The government has recently appealed the *City Gas* decision to the United States Court of Appeals for the Fifth Circuit.

C. Supreme Court Upholds Wisconsin Unitary Tax On Oil Production Income

As it did earlier in 1980 in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), the United States Supreme Court, in *Exxon Corporation v. Wisconsin Department of Revenue*, U.S., 100 S.Ct. 2109 (1980), has rejected a multi-national oil company's attempt to limit its state franchise tax liability through the use of separate accounting methods for intra- and inter-state operations. In so doing, the Supreme Court has again made clear that it will overturn a state's taxation of an integrated multi-national corporation only under extraordinary circumstances.

During the years in controversy (1965-1968), Exxon operations were divided according to function into three departments: exploration and production, refining, and marketing. Transfers of products and supplies among these departments were based on competitive wholesale prices. Because the company had neither exploration and production nor refining operations in Wisconsin, it reflected in its Wisconsin tax returns for the years in question only its marketing operations. As a result, Exxon paid no taxes to Wisconsin for any of those years.

In contrast to Exxon's approach, the Wisconsin Department of Revenue took into account Exxon's income from exploration and production and refining—as well as marketing—notwithstanding Exxon's separate functional accounting for each department. On appeal, the Wisconsin Supreme Court ruled that Exxon was a unitary business and that its income on transfers of crude oil to its own refineries was subject to apportionment.

In the U.S. Supreme Court, Exxon challenged the constitutionality of the Wisconsin decision on both due process and commerce clause grounds. With regard to the due process arguments advanced by Exxon, the Court found that Wisconsin's application of its apportionment statute satisfied the two requirements for state taxation of income of a corporation operating in interstate commerce, namely, the existence of (1) a "minimal connection" between the corporation's interstate activities and the taxing state, and (2) a rational relationship between income attributed to the state and the interstate values of the enterprise. Exxon conceded the nexus of its interstate activities to Wisconsin, but argued that its separate functional accounting evidenced the absence of a rational relationship between Wisconsin and its income from exploration and production and refining. Rejecting this argument, the Court held that a company's internal accounting techniques are not binding on a state for tax purposes and, as a matter of constitutional law, need not be accepted for such purposes. The Court also declared that the "unitary business principle" is the "linchpin of apportionability" for state income taxation of an interstate enterprise, and that a state may apply its apportionment formula to a corporate taxpayer's total income "reasonably related to the activities conducted within the taxing state." In the case before it, the Court found ample evidence that Exxon's marketing operations in Wisconsin were an integral

part of its unitary business

The finding that Exxon was a unitary business provided the court with a nexus sufficient to defeat Exxon's due process clause challenge to the taxation of its income derived from extraction of oil and gas located outside Wisconsin.

In response to Exxon's commerce clause challenge, the Court found that the Wisconsin taxing statute, as applied, did not subject interstate business to an unfair burden of multiple taxation. As in *Mobil Oil, supra*, Exxon failed to establish that it had actually been subject to multiple taxation. Thus, the commerce clause did not require that income from oil and gas production outside Wisconsin be allocated to the states in which they were produced and thereby be exempted from Wisconsin taxation.

D. Tax Court's Decision in Madison Gas and Electric Company Affirmed by Seventh Circuit

In *Madison Gas and Electric Company v. Commissioner of Internal Revenue*, 72 T.C. 721 (1979), the Tax Court held that certain training and related expenditures incurred by a public utility in the expansion of its generating capacity through the joint construction and operation of a nuclear power plant with two other utilities are pre-operating capital expenditures of a new partnership venture and are not deductible by the individual utilities under section 162 of the Internal Revenue Code. In affirming the Tax Court's decision, the U.S. Court of Appeals for the Seventh Circuit held (80-2 U.S.T.C. Par. 9754 (7th Cir. 1980)) that the venture constituted a partnership for tax purposes since the difference between the market value of each venturer's share of the electricity produced and the cost of production attributable to such share represented a profit. The court viewed immaterial the fact that the profits were not realized in cash until the electricity had been channeled through the individual facilities of each partner and subsequently sold to customers.

On appeal, the taxpayer had argued that even if its joint venture were deemed a partnership for tax purposes, the training costs and related expenditures should have been deductible currently since the individual partners were merely expanding their existing, separate businesses. The court, however, interpreted the taxpayer's position as requiring it to ignore the partnership entity as lacking economic substance. Because the partnership was viewed by the court as a separate economic entity, the training and related costs were deemed to be capital in nature since they constituted pre-operational start-up costs of the partnership venture.

E. Courts Disagree Concerning Definition of Wages for Payroll Tax Purposes

Recent decisions evidence a split of opinion among various courts with respect to the treatment of "wages" for purposes of payroll taxes. In *Rowan Companies v. United States*, 624 F.2d 701 (5th Cir. 1980), cert. granted, 49 U.S.L.W. 3509 (No. 80-780, January 19, 1981), the U.S. Court of Appeals for the Fifth Circuit held that the value of meals and lodging furnished an offshore drilling crew for the convenience of the employer constituted "wages" for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). The definition of "wages" for FICA and FUTA purposes, the court held, is not always the same as "wages" for income tax withholding purposes.

Prior to *Rowan*, the U.S. Court of Appeals for the Seventh Circuit in *Oscar Mayer & Co. v. United States*, 623 F.2d 1223 (7th Cir. 1980), had held that the value of the personal use of company automobiles was not wages for FICA and FUTA taxes. In that court's view, the definition of wages is the same for these taxes and for income tax withholding. Similarly, in *Hotel Conquistador, Inc. v. United States*, 597 F.2d 1348 (Ct. Cl. 1979) *cert. denied*, 444 U.S. 1032 (1980), the Court of Claims rejected the Internal Revenue Service's contention that cafeteria meals furnished employees for the convenience of the employer constituted wages subject to FICA and FUTA taxes.

The Fifth Circuit's opinion in *Rowan* is also contrary to the decision of *Royster Company v. United States*, 479 F.2d 387 (4th Cir. 1973). In *Royster*, the Fourth Circuit held that the value of meal reimbursements for salesmen does not constitute wages for purposes of FICA, FUTA, and income tax withholding.

F. Corporate Executive Taxed on Value of Nonbusiness Air Travel Provided by Company

In *Ireland v. United States*, 621 F.2d 731 (5th Cir. 1980), the U.S. Court of Appeals held that the chairman of the board of directors of a corporation realized income when he received from the corporation air transportation between his home in Florida and the corporation's headquarters in Alabama. The chairman lived and worked at his home in Florida in order to prevent management personnel from bringing their problems to him rather than to the president of the company. The chairman frequently traveled on a company plane between his home and the corporate headquarters to attend meetings. The court concluded that the transportation expenses were personal in nature, and that, since the company had borne these expenses for the chairman, the value of the flights was includible in his income. The value was to be fixed by reference to the rates for charter air service between the two cities.

G. Montana Coal Severance Tax Survives Constitutional Challenge

In *Commonwealth Edison Co. v. State of Montana*, 615 P.2d 847 (1980), the Montana Supreme Court upheld the validity of a coal severance tax which had been challenged under the commerce and supremacy clauses of the United States Constitution. The court held that neither the imposition of the tax nor the rate of the tax (20 percent to 30 percent of the coal's value) could be challenged under the commerce clause since the taxable event—the severance of the coal within the state—is an intrastate activity. Thus, the imposition of the tax was held to be within the reserved power of the state to tax the intrastate production or extraction of goods even though such goods may eventually enter interstate commerce. The court also held that the tax does not violate the supremacy clause of the United States Constitution merely because federal statutes and policy encourage the use of coal and other alternate energy sources.

In a related matter, the Senate Committee on Energy and Natural Resources has held hearings on S.2695, a proposal to limit state severance taxes to 12½ percent of the value of coal produced on federal and Indian lands and destined for interstate commerce. Under earlier House versions, the tax ceiling would not be limited to coal produced on federal or Indian lands.

H. Court of Claims Disagrees With IRS On Treatment of Line Pack Gas

In Technical Advice Memorandum 8040005, the taxpayer constructed a gas pipeline connecting the eastern and western United States terminals of another corporation. To continue the uninterrupted flow of gas in the pipeline, the taxpayer must maintain a sufficient volume of gas in the line to keep up the needed gas pressure. This volume of gas, referred to as "line pack," was purchased by the taxpayer from one of its parent corporations.

For tax purposes, the taxpayer treated the cost of original line pack gas as a capital expenditure subject to depreciation. Its position was that line pack was an integral component of the pipeline facilities similar to the pipe, valves, compressors, and other equipment necessary to make the pipeline operational. In addition, the taxpayer contended that the cost of line pack is included as part of the cost of the pipeline facilities for rate base purposes in determining tariffs for transportation.

Contrary to the taxpayer's position, the technical advice concluded that the taxpayer must treat its line pack gas as inventory since it is considered "merchandise in transit." The advice cited both Revenue Ruling 68-20, 1968-2 C.B. 199, and Revenue Ruling 78-352, 1978-2 C.B. 168, for the proposition that, while line pack is important in achieving an efficient system, it is nevertheless considered an integral part of the taxpayer's inventory which will be sold to customers.

The recent decision of the U.S. Court of Claims in *Transwestern Pipeline Co. v. U.S.*, 80-2 U.S.T.C. Par. 9800 (Ct. Cl. 1980), is in direct conflict with this technical advice. Adopting the decision of one of its trial judges, the court held that the cost of line pack gas in Transwestern's interstate pipeline system should be treated for income tax purposes as a capital expenditure depreciable over the useful life of the pipeline, not as a non-depreciable inventory expense. The court's decision was based on four principal findings: (1) that line pack gas is "an indispensable and, in substance, an integral part of the pipeline system, just as the pipe in the pipeline, or the compressors or any other essential component without which the pipeline system cannot operate" (*Id.* at 85,641); (2) that the vast majority of line pack gas will be lost upon abandonment of the pipeline at the end of its useful life, with only a small portion economically recoverable; (3) that line pack gas meets the definition of a fixed asset under generally accepted accounting principles, and capitalization and depreciation of the cost thereof conforms to the best accounting practices in the natural gas industry and to the FPC's Uniform System of Accounts during the period in question; and (4) that capitalization and depreciation of line pack reflects Transwestern's income and matches the company's expenses with its related income in each taxable period throughout the useful life of the pipeline system. The Court of Claims also noted that the IRS characterization of line pack gas as an inventory item was inconsistent with its treatment of "cushion" gas in underground storage reservoirs as a capital expenditure recoupable through depreciation. In the court's view, there is no meaningful distinction between these two categories of nonrecoverable gas.

I. FERC Adopts "South Georgia" Method of Full Normalization

In *Natural Gas Pipeline Company of America*, Opinion No. 108 (Docket Nos. RP77-98, *et al.*, December 23, 1980), the Federal Energy Regulatory Commission was presented with three alternative proposals for allowing Natural to re-

cover, through the tax allowance component of its cost of service, amounts which would have been credited in certain prior years to its deferred tax reserve in Account No. 282 had Natural not been required by the FPC in those years to flow through to its customers the tax benefits from liberalized depreciation. The Commission adopted the "South Georgia" method (which takes its name from *South Georgia Natural Gas Company*, Docket No. RP77-32, wherein the Commission first approved of the method's use as part of a settlement), and, in so doing, appears to have resolved one aspect of a multifaceted issue which directly affects a large number of natural gas pipelines.

Changes in ratemaking policy and in the Internal Revenue Code over the past 25 years have resulted in pipelines deferring, in some years, the tax benefits from liberalized depreciation, and, in other years, flowing through such benefits to customers. During those years where flow-through was used, a pipeline's deferred tax reserve was not augmented; as a result, a pipeline, like Natural, may now find itself in a position where its deferred tax reserve is insufficient to cover, over the pipeline's remaining life, the amount by which its actual tax liability will exceed a tax allowance based on book depreciation rates.

The issue which the Commission faced in *Natural* was how to best achieve three objectives: (1) to restate and update the pipeline's deferred tax accounts to reflect what would have been had the differences between book and tax depreciation always been fully normalized; (2) to provide the pipeline with revenues necessary to meet its greater, future tax liability deferred from prior years and not compensated for in past rates; and (3) to establish the procedure which will govern the calculation of the pipeline's tax allowance for present and future periods.

The Commission held in Opinion No. 108 that the "South Georgia" method best achieves the foregoing objectives. Under that method, the difference between remaining book depreciation on all of the pipeline's depreciable property and remaining tax depreciation on that same property is calculated first. The tax effect of that difference is then calculated, from which the amount in the deferred tax accounts (Account 282 in Natural's case) is subtracted. The remainder, plus the tax-on-tax effect, constitute the pipeline's "unfunded future tax liability." That amount is then amortized through the tax allowance over the remaining book life of the pipeline's property (slightly over 10 years in Natural's case).

The South Georgia method is favored, said the Commission, for two reasons. First, it achieves a more equitable allocation of "transition costs," *i.e.*, the costs of placing the pipeline in a position of "full normalization." Second, its selection enables the Commission to maintain uniformity in ratemaking practice, since that method has been accepted in some 17 prior pipeline rate settlements.

J. *Tax Court Sustains Cycle Meter Reading Method of Accounting as Applied to Utility's Budget Billing Customers*

The Tax Court has sustained a utility's method of accounting for year-end revenues attributable to customers who have chosen a budget billing procedure. In *Bay State Gas Company v. Commissioner of Internal Revenue*, 75 T.C.-No. 36 (CCH) (December 29, 1980), the taxpayer was an accrual-method, calendar-year regulated gas company. It used the cycle meter reading method for recognizing revenue from sales, and recorded revenue from each customer on the appropriate cycle meter reading or estimate date of each month. At the end of each year, the

taxpayer did not recognize any revenue based on a customer's consumption of gas between the December cycle meter reading date and the end of the year. Under the budget billing plan offered as an option to customers, the charges for the entire heating season were estimated in advance and the customer paid one-tenth of that estimate each month with an adjustment at the end of the season. Statements issued to these customers each month showed the amount of charges actually incurred on the basis of the meter readings, in addition to the statement of the one-tenth installment. The taxpayer accrued revenues from budget billing customers as of the meter reading date based on the amount of gas consumed, as in the case of all other customers.

The Commissioner and the taxpayer both agreed that, to the extent that a budget billing customer had in fact paid his December statement during that month, and to the extent that the customer had thus paid for gas consumed through December 31, the taxpayer was required to accrue income for the gas consumed. However, the parties disagreed on whether the taxpayer was required to accrue revenue for charges incurred after the December meter reading date by those budget billing customers who had not in fact made payment in December for those charges. The Tax Court sustained the taxpayer's position and held that no inclusion was required for these year-end revenues.

K. Pennsylvania Commission Orders "Overaccrual" of Accumulated Deferred Income Taxes Amortized to Income and Added to Rate Base

In *Pennsylvania Public Utility Commission v. Philadelphia Electric Company*, 33 PUR4th 319 (1980), the Pennsylvania Public Utility Commission found, *inter alia*, that as a result of the change in federal corporate income tax rate from 48 percent to 46 percent, Philadelphia Electric's accumulated deferred income tax balance as "overstated in the sense that more deferred taxes have accrued in the past than will be amortized in the future." (33 PUR4th at 332.) Accordingly, the Commission ordered that such "overaccrual" (approximately \$325,000) be returned to the utility's customers by amortizing that amount to income over seven years, the period during which the overaccrual was found to have been built up. In addition, the unamortized portion of the overaccrual was ordered to be added to the company's "measure of value" (rate base).

III. IRS RULINGS AND CHANGES IN REGULATIONS

A. Stockholders' Committee Not Tax Exempt

The Internal Revenue Service held in Revenue Ruling 80-107, 1980-1 C.B. 117 (April 21, 1980), that an organization which prepares and files, on behalf of the public utility companies in which its members own shares, statements relating to rate and regulatory matters pending before state public utility commissions and other state and federal regulatory agencies and legislative bodies, does not qualify for tax exemption under section 501(c)(4) of the Internal Revenue Code as a civic league or social welfare organization. The ruling was based on the Service's conclusion that the organization is primarily operated to serve private interests rather than the interests of the community as a whole.

B. *IRS Introduces "Coordinated Examination Program"*

The IRS is undertaking a program which it hopes will result in more uniform treatment of tax issues on an industrywide basis. The utility industry, in general, is included in this program, which is known as the Coordinated Examination Program. Under this program, examining agents will automatically review returns to determine the existence of the following issues, and will adopt the current IRS National Office position with respect to these issues:

1. Nuclear Training and Information Costs

Whether costs incurred in training personnel to operate new generating plants and new nuclear plants prior to commencement of commercial operation are deductible business expenses or capital expense?

If such costs are capital expenditures, what is the proper method of depreciating the asset attributable thereto?

If such costs are capital expenditures, is the asset to which they are attributable properly eligible for the investment tax credit?

2. Reserve for Reprocessing Spent Nuclear Fuel

Is an accrual method utility company engaged in burning nuclear fuel allowed to deduct, in the taxable year in which the nuclear fuel is burned, the estimated cost of reprocessing the spent nuclear fuel?

3. Income Related to Deferred Fuel Adjustment

Whether the taxpayer should accrue income from recoverable fuel expenses during the taxable year in which such expenses are incurred and deducted for tax purposes, or, in the alternative, whether the taxpayer should defer such expenses and deduct them in the taxable year in which the related fuel adjustments are included in income?

4. Income Reportable Under Budget Billing Method

When is income reportable when an accrual basis utility company employs the budget billing method of billing customers?

5. Accrued Income Under Meter Reading and Billing Cycle Method

Can an accrual basis public utility report its income on a meter reading and billing cycle method?

6. Nuclear Plants Investment Credit

Whether buildings constructed at nuclear power stations qualify as special purpose structures eligible for investment credit?

7. Income from Customers' Deposits

Whether customer deposits are includable in gross income?

8. Payroll Tax—Capital vs. Expense

Whether payroll taxes attributable to wages paid by a utility company to its own personnel for construction of capital assets are capital expenditures or deductible business expenses in the taxable year paid or incurred?

C. Deductibility of Expenses of Environmental Impact Studies

The Internal Revenue Service has held that a utility company's expenditures for environmental impact studies prepared in connection with the expansion of its facilities do not qualify as research and experimental expenditures under Internal Revenue Code section 174; however, those expenses may be deductible as business expenses under section 162(a). Revenue Ruling 80-245, 1980-37 I.R.B. 6 (September 15, 1980).

This ruling involved studies which identified suitable locations for a nuclear power plant, ascertained the socio-economic impact of the plant on the surrounding community, predicted the impact of the facility on the terrestrial ecology of the proposed site, considered the commercial disposition of fly ash waste generated by an alternative coal power plant, predicted noise levels at the construction site, considered the impact of construction and operation of the facilities on the aquatic environment of inland streams located on two of the sites, and projected the air pollution and radiation emissions of the coal power and nuclear power facilities. These studies were required by state regulatory agencies which had jurisdiction over the utility's application for a construction permit. The Service held that such costs did not come within the definition of "research and experimental expenditures" contained in the regulations because they were not incidental to the development of an experimental or pilot model, a plant process, a product, a formula, an invention or similar property. The Service did note, however, that the expenses would be either chargeable to a capital account (and thus recoverable through depreciation deductions) or deductible as business expenses under section 162(a).

D. Payroll Taxes Related to Self-Constructed Personal Property Required to be Capitalized; Related Insurance Costs may be Currently Deducted

An electric utility paid social security taxes, unemployment taxes, and group insurance for hospitalization, medical and term life benefits for its employees engaged in the construction of personal property to be used by the utility in its own business. In Technical Advice Memorandum 8040001, the Internal Revenue Service ruled that the election to currently deduct or capitalize taxes under section 266 of the Internal Revenue Code does not extend to a taxpayer involved in the construction of personal property to be used in its trade or business. Thus, relying on the Supreme Court's decision in *Commissioner of Internal Revenue v. Idaho Power Company*, 418 U.S. 1 (1974), the Service concluded that such taxes were required to be capitalized.

In regard to the insurance costs, however, the Service cited I.T. 3408, 1940-2 C.B. 178 as presently controlling. I.T. 3408 held that a taxpayer was permitted to currently deduct expenditures for sick and accident benefits and pension accruals related to the cost of new construction. Although I.T. 3408 is currently being reconsidered by the Service, it was in effect for the years in issue. Therefore, the technical advice memorandum concluded that the insurance costs incurred by the utility were currently deductible.

In a similar factual setting, the Internal Revenue Service again ruled in Technical Advice Memorandum 8043009 that payroll taxes incurred by a utility during the construction of personal property to be used in its own business were required

to be capitalized. In this instance, the employees of the utility were engaged in the construction of various company facilities such as electric generating facilities, transmission and distribution lines and various water projects. The Service interpreted Treasury Regulation section 1.266-1(b)(1)(iii) to permit the option to capitalize or deduct payroll taxes only when the employees' services were rendered in the transportation or installation of purchased assets. Since the facilities (with the exception of general purpose buildings and office buildings) were deemed to be personal property and the costs were considered to be expended for construction rather than installation, the Service concluded that section 266 was not applicable and the payroll taxes were required to be capitalized.

E. Flow Through of Investment Tax Credit

Letter Ruling 8033064 dealt with the provisions of section 46(f)(8) of the Internal Revenue Code regarding the investment tax credit (ITC). The taxpayer, a regulated public utility, provided certain estimates to a regulatory commission. These estimates were determined by inadvertently flowing through all of the additional ITC allowed by the Tax Reduction Act of 1975. The regulatory agency based its decisions on these estimates; as a result, the company received less revenues than it would have received had the decisions of the regulatory agency treated the additional ITC in a manner consistent with Code section 46(f)(2). After reconsideration, the regulatory commission issued another decision which treated the additional ITC in accordance with section 46(f)(2). This later decision did not provide for the recoupment, through adjustment in rates charged to customers during some future period, of the revenue lost as a result of the full flow-through under the earlier decisions. Given these circumstances, the Service held that there would be no disallowance of the additional ITC earned by the taxpayer. Because the earlier decisions were appealed and eventually resulted in the subsequent decision, those earlier decisions were not "final inconsistent determinations", and thus did not trigger disallowance of the investment credit. Furthermore, the later decision, those earlier decisions were not "final inconsistent determinations," and it failed to provide for the recoupment of the additional ITC which was fully flowed through under the earlier decisions.

F. Recapture of Investment Credit on Sale of Undivided Interest in Electric Generating Facility

In Revenue Ruling 80-219, 1980-33 I.R.B. 5 (August 18, 1980), the Internal Revenue Service considered the impact of the investment credit recapture provisions on the sale of an interest in an electric generating facility. The taxpayer was an investor-owned electric utility which owned certain generating facilities which qualified as section 38 property. The taxpayer sold an undivided interest in those facilities to a tax-exempt cooperative. Thereafter, the utility company and the cooperative owned the facilities as tenants in common under a joint operating agreement classified as a partnership. Under these circumstances, the Service held that the sale of the interest in the generating facilities would be treated as a disposition of property, and that there would thus be a recapture of the investment credit with respect to the property transferred. However, there would be no disposition, and therefore no recapture, with respect to the interest retained by the utility company. Furthermore, the contribution of the retained interest to the

partnership would not be a disposition of that property. The Service further held that these conclusions would not be altered if the utility company and the cooperative elected, pursuant to the regulations, to be excluded from the application of the partnership provisions of the Internal Revenue Code.

G. Premature Election of ESOP Credit May Be Revoked

The Internal Revenue Service has ruled that a corporation that elected an employees' stock option (ESOP) credit for the year the credit was earned in accordance with proposed regulations may revoke such election after final and temporary (as contrasted with proposed) regulations were issued. In Letter Ruling 8042107, a corporation attached a statement to its 1977 income tax return electing the ESOP credit for such year. However, the corporation's entire investment credit for that tax year, including the ESOP credit, was unused and was carried forward. After such election was filed, final and temporary regulations were issued providing that an ESOP credit should initially be elected for the first year in which the credit is utilized. The letter ruling concludes that since the corporation relied, to its detriment, on the proposed regulations in filing its ESOP election with its 1977 income tax return, the corporation may treat such election as invalid because of the subsequent issuance of final and temporary regulations. Thus, the corporation will be permitted to elect the ESOP credit attributable to its 1977 taxable year by attaching a statement of election to its income tax return for the first taxable year in which any portion of such ESOP credit is claimed.

H. Investment Tax Credit: Acquisition Contrasted with Construction of Electric Power Plant

In Revenue Ruling 80-312, 1980-47 I.R.B. 6 (November 24, 1980), the Service held that a turbine generating unit was "acquired" by a public utility company under the investment tax credit regulations. However, the addition to an electric generating plant, excluding the turbine generating unit, was "constructed" by the taxpayer within the meaning of the regulations. Therefore, the full ten percent investment credit applied to the turbine generating unit and that portion of the addition constructed after January 21, 1975. However, only the four percent investment credit applied to that portion of the addition constructed prior to that date. The turbine generating unit was acquired because the manufacturer exercised technical direction and authoritative control over its installation, including the furnishing of all test procedures and their application. On the other hand, the taxpayer had a significant degree of continuing control over important details of the construction work, even though the taxpayer had entered into a contract with a general contractor for the work.

I. Timing of Inclusion of Income From Fuel Adjustment Charges

The Internal Revenue Service has held that an accrual-method utility company must include fuel adjustment charges that are applied as part of the rate charged for future sales in its gross income as part of the selling price of fuel sold during the specific six-month period the fuel adjustment charge is in effect. Revenue Ruling 80-308, 1980-46 I.R.B. 7 (November 17, 1980). The taxpayer in question was authorized by the FERC to use a special method to recover its increased gas costs by inserting a "purchased gas adjustment" (PGA) clause in the

company's tariff. Under this clause, the company could adjust its rates every six months to recover its increased gas costs during that period (*i.e.*, the first six months). The fuel adjustment charge was based on estimated sales and was in addition to the normal rate that the company was authorized to charge its customers. It was effective for the succeeding full six-month period (second six months). Any overcollections or undercollections resulting from the fuel adjustment charges were required to be included in the calculation of the fuel adjustment charge for the following six-months (*i.e.*, the third six months). The Service concluded that the "all events" test under the accrual method of accounting was met when the company sold gas during the six months when the fuel adjustment clause was in effect. Thus, this six-month period was the appropriate period for including the fuel adjustment charge in income.

J. Investment Credit For Retired Items That Are Reused

In Revenue Ruling 80-311, 1980-47 I.R.B. 5 (November 24, 1980), the Service considered the treatment, under the investment tax credit provisions, of small items (insulators, cross arms, brackets, etc.) which were recovered as reusable items from retirements of electric utility property. These items were included in the materials and supplies account at the average cost of similar items (new and used) already in the account. The Service concluded that the taxpayer's qualified investment in new section 38 property included the values determined to be the basis of these minor items that were reused. However, since the items were accounted for as mass assets, if the requirements of Treasury Regulation section 1.47-1(e)(2) for the treatment of mass assets were met, the taxpayer could substitute data from an appropriate mortality dispersion table to compute the qualified investment with respect to the reused parts and components. The taxpayer's basis for the minor items would be deemed to be cost for investment credit purposes, unless it could be shown that the use of such basis in computing depreciation resulted in a distortion of income. However, the Service noted that these rulings would not apply to taxpayers electing ADR depreciation, because the applicable regulations require that an asset transferred to a supplies account may not have a basis higher than its unadjusted basis.

K. Internal Revenue Service Position on Employee Fringe Benefits

In Revenue Procedure 80-53, 1980-49 I.R.B. 40 (December 8, 1980), the Internal Revenue Service announced that, in accordance with a Congressional mandate, it would continue to follow existing regulations, revenue rulings, revenue procedures, and case law in determining whether particular fringe benefits are compensation includable in gross income under section 61 of the Code. However, even if a particular fringe benefit is considered to be includable in income, the benefit will not be treated as wages subject to withholding under section 340(a) if (1) the payments are not the type of benefit treated as wages under existing law, and (2) there is a reasonable basis for the belief that the benefit should not be considered as remuneration for services. Nevertheless, those fringe benefits that are includable in gross income as compensation, even though not treated as wages under section 340(a), must be reported by employers as "other compensation" on a Form W-2 prepared for each employee if the total of such compensation paid to the employee and the amount of the employee's wages to be reported on Form W-2

aggregate \$600 or more in a calendar year. The Revenue Procedure specifically stated that it had no effect upon the rules for determining whether fringe benefits are wages for F.I.C.A. and F.U.T.A. purposes.

L. Utility's Entitlement to Investment Tax Credit Not Affected By Treatment of Credit for Ratemaking Purposes

In Letter Ruling 8046032, a regulated natural gas distributor in 1972 filed a conditional election under section 46(e)(2) of the Code. In 1975, after section 46(e) had been redesignated as section 46(f), the taxpayer made another similar conditional election. In 1980, the state public service commission that had jurisdiction over the taxpayer issued an order requiring the taxpayer to account for its investment credit for ratemaking purposes as a taxpayer that had made a ratable flow-through election under section 46(f)(2). The commission required the utility to establish an accumulated deferred investment credit account for all future unamortized investment credits and to amortize these credits annually to reflect reductions in the company's federal tax expense resulting from investment credit taken on public utility property. The Service held that, because of the election under section 46(f)(2), the taxpayer's eligibility to claim the investment credit on public utility property would not be affected by the methods used for computing cost of service and determining the rate base for ratemaking purposes, so long as those methods were consistent with section 46(f)(2). The Service further held that the state commission's requirement that the taxpayer account for all of its investment credit in a manner which assured that the credits were assigned an overall cost of capital rate of return was consistent with the Code and regulations.

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