Report of the Committee on Tax Developments[1] The Tax Reform Act of 1986: Provisions Impacting Utilities

On Wednesday, October 22, 1986, President Reagan signed into law the Tax Reform Act of 1986 (the "Act"),[2] the most sweeping federal tax legislation since the war-time Revenue Act of 1942 (which converted the income tax from a class tax applying only to a few to a mass tax applying to many). The dramatic lowering of marginal tax rates — the central focus of the legislation — will require all taxpayers to reorient the way they think about taxes when making decisions regarding earnings, investments and consumption of goods and services.

The Act retains the individual and corporate income taxes as the primary sources of federal revenue. The bases of these taxes are significantly broadened and rates lowered. The Act is expected to raise the same total revenue as under prior law, but the burden of the income tax is now shifted away from individuals and toward corporations. Individual income taxes will decrease $122 billion (about 5%) through fiscal year 1991, while corporate income taxes will increase $120 billion (about 22%) over the same period. The Act represents both a continuation and a reversal of the Economic Recovery Tax Act of 1981, the major tax initiative of President Reagan's first term. It is a continuation in that the top individual tax rate, which was cut from 70% to 50% in 1981, is now cut from 50% to an effective rate of 33% The highest income taxpayers will be subject to only a 28% marginal tax rate. It is a reversal in that corporate taxes, which were reduced dramatically in 1981, will be higher than they were in 1980, both as a share of total federal revenue and as a share of GNP.

This report outlines the major corporate income tax provisions of the Act which are likely to affect public utilities.

I. Reduction in Corporate Tax Rates

Under prior law corporate taxable income was subject to a five-step graduated tax rate structure. The top corporate tax rate was 46% on taxable income over $100,000. Under the Act, corporate tax rates will be as shown in the following table:

1. This report is a condensation and consolidation of the papers of the panelists appearing on the Tax Reform Act panel at the Mid-Year Meeting, November 7, 1986: Hernan Gonzalez, Tax Partner, Deloitte Haskins & Sells, Columbus, Ohio and William C. Bowers of the law firm of Paul, Hastings, Janofsky & Walker, Atlanta, Georgia.

2. Pub. L. No. 99-514, (to be codified in various sections of 26 U.S.C.).

CORPORATE TAX RATES IN THE TAX REFORM ACT

TAXABLE INCOME	TAX RATE
Not over $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000	34%

The new corporate rate structure phases out the effect of the graduated tax rates at incomes between $100,000 and $335,000. Thus corporations with taxable incomes over $335,000 will be taxed at a flat 34% rate. The revised corporate tax rates are fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that includes July 1, 1987, will be subject to a blended rate that reflects the lower rate for the portion of their year after that date. Thus, for example, a calendar year corporation with taxable income in excess of $1,405,000 would have a blended tax rate of 40% [(46% + 34%)/2] for the year 1987. The applicable rate for such a corporation would be reduced to 34% beginning January 1, 1988.

II. Normalization Requirements for Excess Deferred Taxes

The Act continues the rule that public utility property is eligible for Accelerated Cost Recovery System (ACRS) depreciation only if the tax benefits of ACRS are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. In addition to requiring the normalization of ACRS deductions, the Act provides for the normalization of "excess" deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to depreciation or recovery allowances taken on assets placed in service before 1987). The Act provides that if the "excess" deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the "average rate assumption method", the taxpayer is not considered to be using a normalization method of accounting with respect to any of its assets.

The "average rate assumption method" works in the following manner. Under a normalization method of accounting, additions to the utility's deferred tax reserve are made in the early years of an asset's life in order to reflect the deferral of taxes resulting from the difference between the amount of accelerated depreciation used for tax purposes and the amount of straight-line depreciation used for book purposes. The difference between these two amounts is multiplied by the current federal income tax rate in effect at the time of deferral in order to determine the amount of deferred tax which must be added to the utility's deferred tax reserve. Downward adjustments to the utility's deferred tax reserve are made in later years of an asset's life, when the amount of straight-line depreciation used for book purposes exceeds the amount of depreciation taken for tax purposes. Because the new tax law will decrease the corporate tax rate from 46% to 34%, public utilities which have been making addi-

tions to their reserves for deferred taxes based on the present 46% tax rate, will have an "excess" in their reserve for deferred taxes. The reason for this is that federal income tax deferrals, which had been computed based on a tax rate of 46%, will be "reversed" out when the new tax rate is only 34%. The "average rate assumption method" for calculating reverse timing differences assures the normalization of this "excess" in the utility's reserve for deferred taxes.

EXAMPLE: The following basic example is designed to illustrate how the "average rate assumption method" would work. It ignores basis differences, salvage values, and depreciation conventions.

A piece of equipment costing $1,000 is placed in service in 1985, when the corporate tax rate is 46%. For tax purposes, the equipment is classified as five-year ACRS property. Therefore, the tax depreciation is based on the five-year ACRS table. For book purposes, the utility uses the straight-line method over a ten-year useful life. In 1987, the utility is subject to a blended corporate tax rate of 40%, and in 1988 and years following, the applicable corporate tax rate is 34%. The table below illustrates the normalization of the utility's excess deferred taxes using the average rate assumption method.

ILLUSTRATION OF AVERAGE RATE ASSUMPTION METHOD

	DEPRECIATION			TAX RATE	DEFERRED TAX RESERVE	
YEAR	TAX	BOOK	DIFFERENCE	FACTOR	EXPENSE	BALANCE
1985	150	100	50	46%	23	23
1986	220	100	120	46%	54	77
1987	210	100	110	40%	44	121
1988	210	100	110	34%	37	158
1989	210	100	110	34%	37	195
1990	-0-	100	(100)	39%	(39)	156
1991	-0-	100	(100)	39%	(39)	117
1992	-0-	100	(100)	39%	(39)	78
1993	-0-	100	(100)	39%	(39)	39
1994	-0-	100	(100)	39%	(39)	-0-
	1,000	1,000	-0-		-0-	-0-

As shown in the above table, additions to the utility's deferred tax reserve in years 1985 through 1989 are computed based on the effective tax rates for those years (*i.e.*, 46% in years 1985 and 1986, 40% in year 1987, and 34% in years 1988 and 1989). The reversals from the utility's deferred tax reserve in years 1990 through 1994 are computed using the weighted average of the effective tax rates for years 1985 through 1989 (*i.e.*, (46% x 50 + 46% x 120 + 40% x 110 + 34% x 110 + 34% x 110)/5 = 39%). At the end of 1994, the utility's deferred tax reserve has been reduced to zero and there is no remaining balance.

III. ACRS MODIFICATIONS

The Act retains ACRS subject to certain modifications and reclassifications. In general, the provisions that modify ACRS apply to all property placed in service after December 31, 1986. However, taxpayers may elect to treat property placed in service after July 31, 1986, but before January 1, 1987, under the new ACRS rules. This election may be made on an asset-by-asset basis.

A. *ACRS Transition Rules*

In order to avoid undue hardship in cases where taxpayers had acted in reliance on the ACRS provisions under prior law, the Act contains certain transitional rules. If an asset qualifies as "qualified ACRS transitional property" and is placed in service prior to the applicable deadline, the taxpayer may depreciate the property using the ACRS classifications and rates under prior law, even though the property is actually placed in service after December 31, 1986. In general, in order for property to qualify as "qualified ACRS transitional property," it must fall within one of the exceptions listed below:

- binding contracts — property constructed, reconstructed or acquired pursuant to a written contract that was binding as of March 1, 1986 (December 31, 1985 for ITC);
- self-constructed property — self-constructed property for which (1) construction actually began prior to March 2, 1986 (January 1, 1986 for ITC), and (2) the lesser of $1 million or five percent of the cost of the property was incurred or committed (pursuant to a binding contract) by that date;
- equipped buildings — if an "equipped building" was begun on or before March 1, 1986 (December 31, 1985 for ITC), pursuant to a written, specific plan, and more than one-half the cost (including any machinery and equipment for it) was incurred or committed prior to March 2, 1986 (January 1, 1986 for ITC), the entire equipped building project and incidental appurtenances will be eligible for depreciation (or ITC) under prior law; on the other hand, if less than one-half of the cost of the equipped building was incurred or committed prior to March 2, 1986 (January 1, 1986 for ITC), each item of machinery and equipment is treated separately for purposes of determining whether the item is eligible for depreciation (or ITC) under prior law;
- FERC Projects — qualifying cogeneration or small power production facilities as defined in the Public Utility Regulatory Policies Act of 1978 (PURPA) if on or before March 1, 1986 (same for ITC), the project was licensed or certified by the Federal Energy Regulatory Commission (FERC) or, for hydro-electric projects of less than 80 megawatts, if an application for a license or exemption was filed with the FERC prior to March 2, 1986 (same for ITC);
- plant facilities — a plant facility meeting standards comparable to the equipped building rule (see above);
- sale-leaseback property — property acquired from a person in whose hands it is eligible as transitional property which is leased to such person within 3 months after it is placed in service.

The application of the transitional rules is conditioned on the property being placed in service before a prescribed placed-in-service deadline. Under the ACRS transitional rules, the following placed-in-service rules will apply:

(1) for property with an Asset Depreciation Range (ADR) midpoint of seven or more years, but less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989; (2) for property with an ADR midpoint of 20 years or more, including electric and gas production, transmission, and distribution facilities, as well as residential rental property and non-residential real property, January 1, 1991. For property with an ADR midpoint life of less than seven years (3-year and 5-year ACRS property), the effective placed-in-service deadline is January 1, 1987.

The transition rules for the investment tax credit (ITC) are virtually the same except that the ITC rules also apply to shorter-lived property. These rules are discussed *infra.*

B. *Asset Reclassifications under New ACRS*

The Act modifies the prior ACRS system by prescribing depreciation methods for each ACRS class instead of providing statutory depreciation tables, as under prior law. Under the new ACRS, the method of depreciation in the 3-year, 5-year, and 10-year classes are increased from 150% declining balance (switching to straight-line) to 200% declining balance (switching to straight-line). The new ACRS retains 150% declining balance rates (switching to straight-line) for property in the fifteen-year class.

Under the Act, there are eight ACRS classes. The Act reclassifies certain assets based on ADR midpoint lives and creates a new 7-year class, a 20-year class, a 27.5-year class and a 31.5-year class. The more significant changes and/or reclassifications under the new ACRS are as follows:

- Property with ADR midpoint lives of four years or less (excluding autos, light trucks and truck tractors) is included in the *three-year class* (using 200% declining balance).
- Property with ADR midpoint lives of between 4 and 10 years, is placed in the *5-year class* (using 200% declining balance). The 5-year class also includes computer-based central office switching equipment, research and experimentation property, automobiles (including light trucks and truck tractors), and nuclear fuel assemblies.
- Property with an ADR midpoint life of between 10 and 16 years is included in the *7-year class* (using 200% declining balance).
- Property with an ADR midpoint life of between 16 and 20 years is moved from the 5-year to the *10-year class* (using 200% declining balance).
- Property with an ADR midpoint life of between 20 and 25 years is included in the *15-year class* (using 150% declining balance). The 15-year class also includes nuclear generating plants, sewage treatment plants, telephone distribution plant, and comparable equipment used for the two-way exchange of voice or data commuications.
- Property with an ADR midpoint life of 25 years or more is included in the *20-year class* (using 150% declining balance). The 20-year class also includes electric utility steam production plant (conventional fuels), transmission, and distribution facilities, as well as hydroelectric production plant.
- Residential real property is to be depreciated using the straight-line method over *27 ½ years.*
- Other real property is to be depreciated using the straight-line method over *31 ½ years.*

C. *Additions and Improvements*

The Act provides that the recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service. Any ACRS deduction for an addition or improvement to a property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of post-effective date improvement to a building that constitutes nonresidential real property is recovered over 31.5 years using the straight-line method (i.e., the same recovery period and method that would apply to the building if it were placed in service after the effective date), unless a transitional rule applies to such improvement.

IV. REDUCTION OF GENERAL BUSINESS CREDIT

The general business credit[3] consists of the sum of the following credits: (1) the investment tax credit;[4] (2) the targeted jobs credit;[5] (3) the alcohol fuels credit;[6] and (4) the employee stock ownership credit.[7] Under present law a corporate taxpayer can use the general business credit to reduce tax liability up to $25,000 plus 85 percent of tax liability in excess of $25,000. Unused credits for a taxable year may be carried back to each of the 3 taxable years preceding the unused credit year and then carried forward to each of the 15 following taxable years. The Act limits the amount of income tax liability (in excess of $25,000) of a corporate taxpayer that may be offset by the general business credit to 75% for all taxable years beginning after December 31, 1985. The Act also redefines the general business credit to include the tax credit for increasing research activities,[8] effective January 1, 1986, and it repeals the employee stock ownership credit, effective January 1, 1987.

V. REPEAL OF THE INVESTMENT TAX CREDIT

The Act repeals the ITC[9] for all property placed in service and for all qualified progress expenditures made after December 31, 1985.

A. *ITC Transitional Rules*

The Act provides certain transitional rules, similar to the transitional rules for ACRS, which allow certain kinds of property placed in service after December 31, 1985, to qualify as "qualified ITC transitional property." Thus, even if a taxpayer acquires property and places it in service after December 31,

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3. *See* Internal Revenue Code of 1986, I.R.C. § 38, 26 U.S.C.A. § 38 (West Supp. 1986).
4. I.R.C. § 46 (West Supp. 1986).
5. I.R.C. § 51 (West Supp. 1986).
6. I.R.C. § 40 (West Supp. 1986).
7. I.R.C. § 41 (West Supp. 1986).
8. Pub. L. No. 99-514, § 231(d) (1986)(to be codified at 26 U.S.C. § 41).
9. Pub. L. No. 99-514, § 211 (1986) (to be codified in part at 26 U.S.C. § 46).

1985, "qualified ITC transitional property" will still be eligible for ITC as long as it is placed in service by the prescribed deadline. In general, "qualified ITC transitional property" must fall within one of the exceptions listed above for "qualified ACRS transitional property."[10]

B. Placed-in-Service Deadlines for ITC Transitional Property

For purposes of the ITC transitional rules, the applicable placed-in-service deadlines are: (1) for property with an ADR midpoint less than five years, July 1, 1986; (2) for property with an ADR midpoint of at least five but less than seven years (including computer-based telephone central office switching equipment), January 1, 1987; (3) for property with an ADR midpoint of at least seven but less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989; and (4) for property with an ADR midpoint of 20 years or more (including electric and gas production, transmission and distribution facilities), January 1, 1991.

Under the Act, property that is incorporated into an equipped building or plant facility need not independently satisfy the placed-in-service requirements for qualified transitional property. Instead, such property may qualify for transitional relief as part of the equipped building or plant facility — as long as the equipped building or plant facility is placed in service by the prescribed deadline. Thus, for example, an initial core nuclear fuel assembly that is purchased for a nuclear power plant presently under construction would not independently satisfy the placed-in-service requirements of the ITC transitional rules unless it is placed in service before January 1, 1987, since nuclear fuel assemblies have an ADR midpoint life of 5 years. However, the fuel assembly would still qualify for ITC under the plant facility rule if the following conditions are satisfied: (1) more than one-half of the cost of the nuclear construction project was incurred or committed prior to January 1, 1986; and (2) the new nuclear plant was placed in service prior to January 1, 1991.[11]

C. Reduction of ITC Carryforward Credits

For tax years beginning after July 1, 1987, the Act provides for a one-time reduction in the amount of ITC claimed under transitional rules as well as ITC carryforward credits from prior years. The amount by which the credit is reduced pursuant to these rules will not be allowed as a credit in any subsequent taxable year. This one-time ITC reduction is 35% and is fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that straddles July 1, 1987, will be subject to a pro rata reduction. Thus, a calendar year-end taxpayer will be subject to the one-time reduction of 17.5% in 1987 and 17.5% in 1988.

The phased-in 35-percent reduction is to be applied to the ITC before application of the 75-percent limitation on the general business credit. Further, the amount of ITC carryovers subject to reduction shall be adjusted to reflect credits that have been recaptured.

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10. *See supra* Section III.
11. *See* discussion of transitional rule for plant facilities, *supra* Section III.

D. Full Basis Adjustment

In addition to the one-time ITC carry forward reduction described above, the Act requires taxpayers to reduce the tax basis of any transitional property by the full amount of the ITC claimed with respect to such property. The full basic adjustment rule applies to all depreciable ITC property placed in service after December 31, 1985 — regardless of whether such property is eligible for ACRS depreciation.

Under prior law, taxpayers had to reduce the tax basis of ITC property by 50% of the ITC claimed with respect to that property, or elect to claim a reduced credit (*i.e.*, 4% with respect to 3-year ACRS property and 8% with respect to all other recovery property) in lieu of the required basis reduction. Under the Act, there is no corresponding provision under which a taxpayer may elect to claim a reduced ITC amount in lieu of the full ITC basis reduction. The amount of the full basis adjustment is to be based on the reduced amount of the ITC (*i.e.*, after application of the phased-in 35-percent reduction, described above). Thus, for transition property that is eligible for a 6.5 percent ITC (i.e., 10% — [10% x 35%]), the required basis reduction would be with respect to the 6.5% credit, not the unreduced 10% credit.

EXAMPLE: The example below illustrates the application of the ITC transitional rules in conjunction with the reduced tax limitation (*i.e.*, 75% offset of tax liability) on the general business credit.

For the calendar taxable year ended December 31, 1987, a corporation has a tax liability before tax credits of $100,000. The corporation has ITC carried forward from 1986 and prior years of $100,000, and transitional ITC from property placed in service in 1987 of $100,000. The corporation has no other general business tax credits.

The corporation's after-credit tax liability for 1987 will be $18,750, computed as shown below.

Carryforward ITC:	$100,000
17.5% Reduction of Carryforward ITC:	(17,500)
Transitional ITC Earned in 1987:	100,000
17.5% Reduction of Transitional ITC:	(17,500)
ITC Subject to General Business Credit Limitation:	$165,000
First $25,000	$ 25,000
75% limit on excess of first $25,000 [.75 x (100,000 - 25,000)]	56,250
Limit on General Business Credit:	$ 81,250
ITC Carryforward to 1988: ($165,000 - $81,250)	$ 83,750
Calculation of 1987 tax liability:	
Tax liability before ITC:	$100,000
ITC allowed in 1987:	$(81,250)
After-credit tax liability:	$ 18,750

The corporation may thus carry forward $83,750 of its ITC to calendar year 1988. Furthermore, under the full basis reduction requirements of the ITC transitional rules, the tax basis of the taxpayer's transitional property will be reduced by $82,500 — the reduced amount of the ITC claimed with respect to that property (*i.e.*, $100,000 — $17,500).

Assume for 1988 the corporation again has a before-tax-credit tax liability of $100,000. However, in addition to the $83,750 of ITC carried forward from 1987, the corporation has claimed an additional ITC of $50,000 with respect to qualified transitional property. Assume that the corporation has no other general business credits. The corporation's after-tax-credit tax liability will again be $18,750, computed as shown below:

Carryforward ITC:	$ 83,750
17.5% Reduction of Carryforward ITC:	(14,656)
ITC earned in 1988:	50,000
35% Reduction of Transitional ITC:	(17,500)
ITC Subject to General Business Credit Limitation:	101,594
First $25,000	25,000
75% limit on excess of first $25,000 [.75 x (100,000 - 25,000)]	56,250
Limit on General Business Credit:	$ 81,250
ITC Carryforward to 1989: ($101,594 - $81,250)	$ 20,344
Calculation of 1988 Tax Liability:	
Tax liability before ITC:	$100,000
ITC allowed in 1988:	(81,250)
After-credit tax liability:	$ 18,750

In the above example the corporation will have $20,344 remaining ITC that it can carry forward. This amount will not be subject to any further reduction under the proposed ITC reduction rules. Finally, under the full basis reduction requirements of the ITC transitional rules, the tax basis of the taxpayer's transitional property will be reduced by $32,500 — the reduced amount of the ITC claimed with respect to that property (i.e., $50,000 — $17,500).

E. Extension of Certain Energy tax Credits

Although many of the energy tax credits had already expired or were scheduled to expire prior to enactment of the Act, some business energy tax credits were extended. Alternative energy projects for which credits still apply are as follows:

- solar energy property — 15% for property placed in service in 1986, 12% in 1987, 10% in 1988;
- geothermal property — 15% in 1986, 10% in 1987 and 1988;

- biomass property — 15% in 1986, 10% in 1987; and
- ocean thermal property — 15% through 1988.

There are also transition rules which remain in effect for long lead-time projects which meet existing criteria.

VI. Stricter Normalization Requirements for ITC

The Act provides that if the tax benefits of previously allowed investment tax credits on public utility property are not normalized, then certain investment tax credits will be recaptured. In general, the amount recaptured is the greater of (1) all investment tax credits for open taxable years of the taxpayer, or (2) unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not for open years), whichever is applicable. If such credits have not been utilized and are being carried forward, the carryforward amount is reduced in lieu of recapture. These rules apply to violations of the relevant normalization requirements occurring in taxable years ending after December 31, 1985. Similar principles apply to the failure to normalize the tax benefits of previously allowed employee stock ownership plan credits.

VII. New Alternative Minimum Tax

Under prior law, corporations were subject to an add-on minimum tax equal to 15% of the corporation's tax preferences, to the extent the preferences exceeded the greater of $10,000 or the regular income tax paid. The Code set forth the categories of tax preferences.[12] Among others they included excess ACRS deductions on real estate, excess of percentage depletion over cost basis, and the "untaxed" portion of capital gains. The Act repeals the add-on minimum tax for corporations beginning in 1987, and replaces it with a new corporate alternative minimum tax.

The tax base for the new corporate alternative minimum tax is the corporation's regular taxable income to which is added the tax preferences for the year. After certain adjustments, the resulting amount, called alternative minimum taxable income, is reduced by an exemption amount and is subject to tax at a 20% rate. The exemption amount of $40,000, is reduced (but not below zero) by 25% of the amount by which alternative minimum taxable income exceeds $150,000. Thus, for corporations with alternative minimum taxable income over $310,000, the exemption amount is zero (*e.g.* $40,000 — [($310,000 — $150,000) x .25] = 0). Steps for computing the corporate alternative minimum tax are illustrated below:

12. *See* Internal Revenue Code of 1954 § 57, 26 U.S.C. § 57 (1982).

	Taxable Income
+	Tax Preferences
	Alternative Minimum Taxable Income
−	Exemption Amount
	Alternative Minimum Tax Base
x	.20
	Tentative Minimum Tax

Under the Act, a corporation's tax liability for any given tax year will be the greater of: (1) its regular income tax liability; or (2) the tentative minimum tax (computed as shown above), as reduced by available tax credits.

A. *Investment Tax Credits*

Under prior law taxpayers could not use tax credits to offset the corporate add-on minimum tax. However, the Act permits taxpayers to use both general business tax credits (including ITC) and foreign tax credits to reduce their minimum tax liability.

The Act provides that corporations may use general business credits (including carryforward and transitional ITC) to reduce minimum tax liability only to the extent that this reduction does not exceed 25% of the corporation's tentative minimum tax liability (foreign tax credits may be used to offset as much as 90% of tentative minimum tax liability). Credits which cannot be used by the taxpayer due to the application of this 25-percent limitation may be carried over to other taxable years under the rules generally applicable to credit carryovers. Thus, under the new tax law a corporate taxpayer with tentative minimum tax liability of $4 million will be able to use its available investment tax credits (after the 35-percent reduction in ITC) to offset up to $1 million of its tentative minimum tax liability; any remaining ITC may be carried forward to subsequent tax years.

The Act further provides that taxpayers may use net operating losses (NOL's) generated in prior taxable years to offset as much as 90% of their alternative minimum taxable income. However, the Act provides that for NOL's generated in taxable years beginning after December 31, 1986, the amount of the NOL must be reduced by the amount of any tax preferences arising in the year that the NOL was generated.

B. *New Alternative Minimum Tax Preferences*

The Act retains most of the tax preference items under the add-on minimum tax, with a few extensions and modifications. These are summarized below:

- *Excess Accelerated Depreciation on Real Property.* The Act continues the prior law tax preference for excess accelerated depreciation on real property. However, the Act modifies the computation of this preference item with respect to all real property

(other than qualified ACRS transitional property) placed in service after 1986 to be equal to the amount of the depreciation deduction allowed under the new ACRS for regular tax purposes, minus the amount of depreciation as computed using the straight-line method over a 40-year useful life.

EXAMPLE: A company owns an office building with an original tax basis of $10 million. The building does not qualify as ACRS transitional property under the new Act and is therefore depreciated for regular tax purposes in accordance with the new ACRS using the straight-line method over a 31.5 year useful life. The alternative minimum tax preferences on excess accelerated depreciation on real property is, therefore, $67,460 (*i.e.*, [$10,000,000/31.5] minus [$10,000,000/40]).

- *Excess Accelerated Depreciation on Personal Property.* The Act generally extends the excess accelerated depreciation preference provision to apply to all ACRS property — both real and personal (other than ACRS transitional property) — that is placed in service after 1986. Accelerated depreciation on property placed in service prior to 1987 (as well as ACRS transitional property) will be treated as a tax preference only to the extent that it constituted a preference under prior law.

The amount of the tax preference for excess accelerated depreciation on personal property is computed in the following manner. For minimum tax purposes, depreciation on personal property is computed using the 150% declining balance method over the asset's ADR midpoint life. The preference amount is then the difference between the amount of the alternative minimum depreciation (described above) and the company's ACRS depreciation deduction used for regular income tax purposes.

EXAMPLE: A nuclear generating plant, having an original tax basis of $800 million, is placed in service in 1992. The plant has an ADR midpoint life of 20 years,[13] and is classified as 15-year ACRS property under the new ACRS. Because the plant was not placed in service before January 1, 1991, it does not qualify as ACRS transitional property. The depreciation deduction for regular tax purposes is $40 million (*i.e.*, [($800 million/15) x 1.5] / 2), and the alternative minimum tax depreciation is $30 million (i.e., [($800 million/20) x 1.5] / 2). The excess accelerated depreciation tax preference is, therefore, $10 million (*i.e.*, $40 million minus $30 million) — the amount of the regular tax depreciation less the amount of the alternative minimum tax depreciation.

Finally, the Act provides that, in computing the amount of the tax preference for excess accelerated depreciation on post-1986 ACRS property, a corporation will be allowed to "net" the excess of alternative minimum tax depreciation over regular tax depreciation (on older post-1986 ACRS property) against the excess of regular tax depreciation over alternative minimum tax depreciation (on recently acquired post-1986 ACRS property). While this provision may afford corporate taxpayers some measure of relief in later years when the depreciation on post-1986 ACRS assets "turns around", it will provide very little relief in the immediate future.

- *Rapid Amortization of Pollution Control Facilities.* As under prior law, rapid amortization of certified pollution control facilities will continue to be treated as a tax preference, with slight modifications, for facilities placed in service after 1986.

- *Percentage Depletion.* The Act continues the prior tax law preference for percentage depletion deductions in excess of the property's adjusted basis.

- *Mining Exploration and Development Costs.* Under the prior tax law, the amount of mining exploration and development costs that were expensed for regular tax purposes, minus the amount which could have been deducted if these same costs had been capitalized and amortized ratably over a 10-year period, was treated as a tax preference item — but only with respect to personal holding companies (PHC's). The Act extends this tax preference to apply to all corporate taxpayers.

13. *See* Rev. Proc. 77-10, 1977-1 C.B. 548, 565.

- *Intangible Drilling Costs.* The Act retains the intangible drilling cost tax preference — only applicable to individual taxpayers under prior law — and extends it to corporations. The Act treats as a corporate tax preference item the amount by which the corporation's excess intangible drilling cost deductions exceed 65% of the corporation's net oil and gas income.[14]

C. *New Tax Preference on Reported Profits*

In addition to the tax preference items listed above, the Act treats as a tax preference one-half of the amount by which the adjusted gross book income (*i.e.*, net book income plus Federal and foreign taxes) of the corporation exceeds its alternative minimum taxable income (AMTI), as determined before any amount is added to alternative minimum taxable income as a result of this preference. Thus, for example, if a corporation had regular taxable income of $1 million, gross book income (*i.e.*, net book income plus taxes) of $4 million, and other tax preferences of $1 million, the corporation's alternative minimum taxable income would be $3 million, as shown below.

Regular Taxable Income:	$1,000,000
Other Tax Preferences:	1,000,000
AMTI Before Book Income Preference:	$2,000,000
Tax Preference on Reported Profits: [($4,000,000 - 2,000,000)/2]	1,000,000
Alternative Minimum Taxable Income:	$3,000,000

The new "book income" tax preference on reported profits will have a major impact on the public utility industry. This is because book income, for purposes of calculating the tax preference amount, includes earnings from allowance for funds used during construction (AFUDC) as well as other accruals that are not includible in regular taxable income. Thus, the new tax law, in effect, treats one-half of the earnings from AFUDC as a tax preference item, and this amount is now subject to tax at the 20% corporate alternative minimum tax rate. Since AFUDC generally accounts for approximately 46% of utility earnings (according to an Edison Electric Institute estimate), this provision is likely to have serious tax implications for many utilities.

D. *New Tax Preference on Adjusted Current Earnings*

For taxable years beginning after December 31, 1989, the tax preference on book income will be replaced by a new tax preference on "adjusted current earnings". For taxable years in which this preference applies, alternative minimum taxable income will be increased by 75% of the amount by which adjusted current earnings exceeds alternative minimum taxable income (before this adjustment), regardless of whether alternative minimum taxable income and adjusted current earnings are positive or negative amounts.

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14. *See* I.R.C. § 57(a)(11) (1982 & Supp. III).

Adjusted current earnings will include items of income or expense — such as interest on tax-exempt bonds — that are included in computing regular earnings and profits, but are never included in the computation of either regular or alternative minimum taxable income.

The details of these provisions are to be "fleshed out" pending further review by the Treasury Department. The Conference Report directs the Treasury Department to study and to report regarding the book income and earnings and profits provisions, including any refinements that may be appropriate. The final report is to be submitted to the House Ways and Means Committee and the Senate Finance Committee by January 1, 1989.

E. *Alternative Minimum Tax Credit*

Under the Act, the excess of a corporation's alternative minimum tax liability over its regular tax liability (except to the extent attributable to exclusion preferences such as tax-exempt interest) may be carried forward as a credit against any subsequent-year regular tax liability in excess of its alternative minimum tax. The amount of this credit is not to be reduced by any investment tax credits used to offset the minimum tax liability.

The minimum tax credit will provide some relief from the minimum tax resulting from timing differences between the regular and minimum taxes. However, since there is no carry-back for the minimum tax credit, the relief will be inadequate when a company books a large liability *before* it is recognized for tax purpose.

F. *Normalization Requirements Under the New Alternative Minimum Tax*

Section 701(a) of the Act contains a provision requiring public utilities to use a normalization method of accounting for the effects of the alternative minimum tax. This provision will apply to all depreciable property for which utilities are required to use a normalization method of accounting for the differences between tax and book depreciation. Thus, it will require normalization accounting for pre-ACRS assets[15] as well as ACRS assets.[16]

However, the full extent and scope of this normalization requirement is far from clear — either from the language of the Act or from the various committee reports. The precise methodology for a normalization method of accounting for the effects of the alternative minimum tax will not be known until regulations are issued by the Treasury Department in accordance with the provisions in the new Act.

G. *Estimated Tax Payments*

Under prior law corporations were not required to make estimated tax payments with respect to minimum tax liability. The Act requires that estimated tax payments be made with respect to minimum tax liability for taxable years beginning after December 31, 1986.

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15. I.R.C. § 167(1) (West 1984 & Supp. 1986).
16. I.R.C. § 168(e) (West 1984 & Supp. 1986).

VIII. Capitalization Rules for Interest and Overheads

The Act includes uniform capitalization rules which require the capitalization of construction period interest and other overhead expenses. Under prior law, taxpayers were allowed current deductions for these expenses. The rule requiring capitalization of construction period interest expenses applies generally to the following kinds of properties: (1) real property; (2) other property with a class life (as defined under the Act) of 20 years or more; and (3) all other property with a construction period of more than two years (or one year in the case of items costing more than $1 million). Since most public utility property generally falls under the second and third categories, this provision will have a major impact on the public utility industry.

Under the Act, debt that can be specifically traced to production or construction expenditures first must be allocated to production or construction. If production or construction expenditures exceed the amount of this debt, interest on other debt of the taxpayer must be treated, to the extent of this excess, as production or construction period interest. For this purpose, the assumed interest rate is to be an average of the rates on the taxpayer's outstanding debt (excluding debt specifically traceable to production or construction).

The Conference Report specifically states that taxpayers are required to use the avoided cost method in determining the amount of interest expense allocable to production, irrespective of whether the avoided cost method (or a similar method) is required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. This means that public utilities must apply the avoided cost method of determining capitalized interest, even though a different method is authorized or required by FASB 34[17] or by the regulatory authority having jurisdiction over the utility.

The new interest capitalization rules apply to costs incurred after December 31, 1986, unless incurred with respect to property on which substantial construction had already occurred prior to March 1, 1986.

IX. Contributions in Aid of Construction and Customer Advances

The Act subjects contributions in aid of construction (CIAC) and customer advances to taxation as ordinary income.

Under prior law,[18] CIAC was not included in a public utility's gross income and was therefore not subject to taxation. Thus prior tax law permitted regulated public utility providers of electric, gas, water or sewage services to treat CIAC as non-taxable contributions to capital. However, prior tax law also provided that no income tax deductions were allowable with respect to CIAC. Thus property purchased with CIAC could not be depreciated for tax purposes, nor could any ITC be claimed with respect to such property.

The Act repeals the above-described special provisions pertaining to CIAC. Under the Act, CIAC is to be taxed as ordinary income in the year

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17. *Financial Accounting Standards Board*, "Statement of Financial Accounting Standards No. 34: Capitalization of Interest Cost" (Oct. 1979).

18. I.R.C. § 118 (West 1984 & Supp. 1986).

received. However, property purchased with these funds can now be depreciated for tax purposes under ACRS or any other applicable depreciation method. However, no ITC will be available under the new tax law.

X. UNBILLED UTILITY REVENUES

The Act contains a provision requiring public utilities to include "unbilled revenues" in taxable income for the year in which the utility services are rendered to customers. This provision, in effect, legislatively overrides the Tax Court's recent decision in *Orange and Rockland Utilities v. Commissioner*,[19] which held that the meter reading/billing cycle method of accounting is a proper method of accounting for federal income tax purposes.

The Act requires public utilities to estimate the income attributable to utility services provided during the taxable year but after the final meter reading or billing date which falls within the taxable year. Where it is not practical for the utility to determine the actual amount of services provided through the end of the current year, this estimate may be made by assigning a *pro rata* portion of the revenues determined as of the first meter reading date or billing date of the following taxable year. This provision applies to all public utilities including electric and gas utilities, water or sewage disposal companies, and telecommunications companies. Whether or not a utility service is regulated by a government or governmental agency does not affect its treatment under this provision.

This provision is effective for taxable years beginning after December 31, 1986. The Act provides that the adjustment to income resulting from this change in accounting method is to be included in the utility's taxable income ratably over a four-year period.

The required tax adjustment for unbilled revenues can be illustrate by the following example. Assume that a tax calendar year-end public utility uses the meter reading/billing cycle method in computing taxable income. The utility has unbilled revenues of $10 million on December 31, 1985, and unbilled revenues of $12 million on December 31, 1986. The utility's taxable income for the tax year 1986 thus includes the $10 million of unbilled revenues from 1985, but does not include the $12 million of unbilled revenues from 1986. The balance of the utility's unbilled revenue account as of December 31, 1986 must be taken into income ratably over the following four-year period. Thus, the utility's taxable income for years 1987 through 1990 will be increased by $3 million ($12 million divided by 4) as a result of this adjustment.

A. *Existing Taxpayer Disputes Resolved*

The Act lays to rest existing controversies between the IRS and public utilities relating to the taxability of unbilled revenues in prior tax years. The Act specifically states that the meter reading/billing cycle method of determining taxable income shall be deemed proper for Federal income tax purposes for any tax year beginning before August 16, 1986. Thus the provisions of the Act

19. 86 T.C. 199 (1986).

concerning unbilled revenues are to be applied prospectively only, and cannot be applied to any taxable year beginning before August 16, 1986.

XI. Reserve for Bad Debts Disallowed

Prior income tax law permitted taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allowed a deduction at the time and in the amount that any individual debt became wholly or partially worthless. The reserve method allowed a current tax deduction for the amount that was necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year.

The Act repeals the availability of the reserve method in computing the deduction for bad debts. Thus, under the new Act, taxpayers are no longer able to use the so-called "Black Motor" formula[20] or any other reserve methods in computing their deduction for bad debts. Rather, taxpayers are now required to use the specific charge-off method in computing their bad debt losses. It is important to note that the Act retains the requirement that a partially worthless debt must be charged off on the taxpayer's books in order to be deductible for tax purposes. However, a wholly worthless debt is deductible in full in the year that it becomes worthless — as was the case under prior law — regardless of whether the debt is written off on the taxpayer's books. The Conference Report specifically states that in determining whether a debt is worthless, the fact that a public utility is required to continue to provide services to a customer whose account has otherwise been determined to be uncollectible, is not to be considered evidence that the debt is not worthless for Federal income tax purposes.

The provision of the new Act repealing the use of the reserve for bad debts is generally effective January 1, 1987, and applies to all taxpayers except small commercial banks and thrift institutions. The Act provides that the balance of a taxpayer's reserve for bad debts on the effective date (*e.g.*, January 1, 1987) is to be taken into income ratably over a four-year period. Thus, if a taxpayer's reserve for bad debts was $2 million on December 31, 1986, the taxpayer's taxable income for years 1987 through 1990 is to be increased by $500,000 per year to reflect the ratable inclusion of the final balance of the reserve for bad debts on December 31, 1986.

XII. Deferral of Bond Redemption Income Disallowed

Taxpayers are generally required to include in gross income the amount of any discharge of indebtedness to the extent that the taxpayer is solvent following the discharge. A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of indebtedness discharged is equal to the difference between the face amount of the debt, as adjusted for any unamortized premium or discount, and any consideration given

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20. *See* Black Motor Co. v. Comm'r, 41 B.T.A. 300 (1940), *aff'd*, 125 F.2d 977 (6th Cir. 1942).

by the taxpayer to effect the discharge.

In the case of a discharge or redemption of qualified business indebtedness, (*i.e.*, indebtedness incurred in connection with property used in a trade or business), the prior tax law contained a special election allowing a corporation to reduce the basis of depreciable assets instead of including the amount of the discharge income in taxable income.[21] This provision was particularly useful because it enabled companies to redeem their outstanding debt without recognizing taxable income. For example, under this provision of the prior tax law, a corporation could redeem an outstanding issue of bonds having a tax basis of $10 million (e.g., face value of $10 million plus unamortized premium of $100,000) for only $9 million, without recognizing any taxable income. By making a special election, the company could defer recognition of the gain on the exchange. Thus, instead of taking the $1,100,000 into income currently, the company could postpone the recognition of this income by electing to reduce the basis of the associated property (*i.e.*, property that the bonds were initially issued to finance) by the amount of the gain.

Effective January 1, 1987, the Act repeals the special provisions under prior tax law which allowed solvent taxpayers to defer bond redemption income by electing to reduce the tax basis of the associated depreciable assets. Corporations are no longer able to defer the recognition of discharge of indebtedness income associated with the redemption of bond issues.

XIII. Provisions Affecting IDB's

Under prior law, interest on industrial development bonds (IDB's) was not taxable if the bonds were issued to finance certain exempt activities. These exempt activities included sewage disposal facilities, solid waste disposal facilities, facilities for furnishing electric energy or gas locally, air or water pollution control facilities, facilities for furnishing water, and local district heating and cooling facilities.

Under the Act, an issue of IDB's will qualify for the exemption only if 95% or more of the bond proceeds (compared to 90% under current law) are used to finance one or more exempt facility. The Act retains tax exempt status for sewage and solid waste disposal facilities, facilities for furnishing water, facilities for furnishing electric energy and gas locally, and local district heating and cooling facilities. The Act also adds an exemption for hazardous waste treatment facilities (but excludes radiation waste facilities). The Act eliminates the exemption for air or water pollution control facilities allowed under current law. These provisions apply to all IDB's issued after August 15, 1986; however, the rules do not apply to bonds described in an inducement resolution adopted before September 26, 1985 and issued with respect to property meeting any of the following criteria:

- Original use commenced with the taxpayer and construction commenced before September 26, 1985 and is completed on or after such date;
- Original use commenced with the taxpayer, a binding contract to incure more than 10% of the project cost was entered into before September 25, 1985, and some ex-

21. *See* I.R.C. § 108 (West 1984 & Supp. 1986).

penditures occurred after that date; or

- The property was acquired on or after September 25, 1985, pursuant to a binding contract entered into before such date.

Generally, the new rules do not apply to refundings of bonds not subject to the new rules, if the amount of the refunding issue does not exceed the refunded bonds and certain limits on maturity dates are satisfied.

There is also an alternative depreciation system for tax-exempt bond financed property which requires straight-line depreciation based on the ADR midpoint. The new rules apply to property placed in service after 1986 which is financed with bonds (including refunding bonds) issued after March 1, 1986.[22] The rules do not apply to facilities described in an inducement resolution or other preliminary approval obtained before March 1, 1986 for which one of the following exceptions applies:

- Original use commenced with the taxpayer and construction commenced before March 2, 1986;
- There was a binding contract before March 2, 1986, to incur more than 10% of the reasonably anticipated costs, and some expenditures were incurred on or after that date; or
- The property was acquired on or after March 2, 1986, pursuant to a binding contract entered into before such date.

N. Beth Emery, *Chairman*
Robert Y. Hirasuna, *Vice Chairman*

B. Melvin Hurwitz
James R. Lacey

Walter J. Sczuldo
Walter Joseph Stewart

22. Tax Reform Act of 1986, § 203(c).