Report of the Committee on Tax Developments

I. Introduction

Since the events described in the last Committee Report, 5 *Energy L.J.* 503 (1984), several issues have arisen that affect the tax planning and potential liability of energy companies, electric utilities, natural gas companies, and oil and natural gas producers. Among the most significant were a decision of the United States Court of Appeals for the First Circuit on yet another variation of the flowthrough/normalization controversy; changes in the tax laws; and several Internal Revenue Service rulings on the income tax liabilities of public utilities.

II. Court Decisions

As reported in the last Committee Report, FERC Opinion Nos. 178 and 178-A, *Distrigas of Massachusetts Corp.*, 23 FERC ¶ 61,416, *reh'g. denied,* 24 FERC ¶ 61,250 (1983), addressed the issue of whether a pipeline's unfunded future tax liability could be recovered through rates. The Commission held that because earlier tax savings were retained by the company and not passed on to customers, customers would not be liable for the increased tax liability when the timing differences reverse. The Commission also held that the company's use of accelerated depreciation for tax purposes, but not for rates, contributed an effective replacement for capital that otherwise would have been supplied by investors. As a result, the Commission required the company to increase its deferred account by the amount of tax saving and to reduce its rate base accordingly.

On appeal, in *Distrigas of Massachusetts v. FERC,* 731 F.2d 1200 (1st Cir. 1984), the First Circuit thus addressed yet another variation of the flowthrough/normalization controversy. The Court affirmed the Commission's decision to allocate the burden of unfunded future tax liability on shareholders, but set aside the Commission's decision to reduce the company's rate base as arbitrary, based upon the particular nature and historical characteristics of the company.

The issue of the unconstitutionality of taxes burdening interstate commerce was addressed by the Louisiana Court of Appeals in *Mississippi River Transmission Corp. v. Simonton,* 442 So.2d 764 (La. Ct. App. 2d Cir. 1983). In that case, the court held that natural gas stored in Louisiana to service contractual customers outside of the state was not exempt from Louisiana's taxation under the commerce clause. The court rejected the argument that gas that had been stored, but not sold, in Louisiana was exempt from taxation as interstate commerce. The court reasoned that the continuity of transit had been broken for an economically expedient purpose, thus permitting taxation without violation of the commerce clause.

In aother decision that affects the tax liability of energy utility companies, the United States Tax Court held that deposits received from customers are better characterized as prepayments on income items, such as discharge of a bill, rather than as security for non-income producing covenants, such as covering damage to a meter or other company-owned property. As a result, in *City Gas Co. of Florida v. Commission,* 47 T.C.M. (CCH) 971 (Jan. 26, 1984), the court held that the deposits constituted taxable income to the company rather than refundable security deposits. The court based its decision upon an evaluation of the "primary purpose" of the deposits and the fact that the company had the unfettered use and control of the deposits. In this case, the deposits were, in fact, applied to discharge the obligations of a final bill. The court did not address the issue of the tax effect of deposits that are refunded to customers rather than used as prepayments.

Finally, the United States Claims Court, in *Cleveland Electric Illuminating Co. v. United States,* 54 A.F.T.R. 2d (P-H) 84-6252 (Oct. 30, 1984), ruled that the depreciation capitalized as part of self-constructed utility property does not give rise to additional investment tax credits ("ITCs"). In that case, Cleveland Electric Illuminating Company ("CEI") used its own equipment in constructing improvements and additions to its capital facilities. CEI took the appropriate ITCs on the equipment when purchased. CEI deducted depreciation on the construction equipment as it was used in construction. In addition, CEI included the depreciation in the basis of the newly-constructed property when it calculated the ITCs on the constructed property. The IRS disallowed the depreciation deduction and instead capitalized depreciation as part of the cost of the newly-constructed property. Additionally, the IRS refused to allow CEI to include the depreciation in calculating the ITC on the basis that the effect would be to permit the ITC to be taken twice on a single investment.

The Claims Court refused to alter the IRS' calculation of the ITC and thus refused to allow CEI to include depreciation in calculating ITCs on the newly-constructed property.

III. Commission Decisions

In a recent decision, the FERC extended earlier rulings that investors in proposed sales and lease-backs were not public utilities under the Federal Power Act, thus permitting transfers of ITC's from utilities to non-regulated investors for facilities that are clearly subject to FERC jurisdiction. In *Public Service Company of New Mexico* ("PNM"), 29 FERC ¶ 61,387 (1984), PNM proposed the sale and lease-back of a newly-constructed jurisdictional transmission line and related facilities to facilitate the financing for the construction of the new line. Additionally, the transaction offered the advantages of cost saving as a result of: (1) the lessor's ability to finance a greater proportion of the line with debt; (2) favorable utilization of ITC's and accelerated depreciation benefits by the lessor; and (3) the use by PNM of "off balance sheet" financing, by which lease payments would be expensed rather than capitalized. Because the investors did not operate the line and were not in the business of selling, producing, or transmitting electric power, the FERC disclaimed jurisdiction over the non-utility participants.

IV. IRS Rulings

Several IRS rulings during the past year will have an effect on the tax liability of energy companies. A synopsis of the most significant rulings follows:

A. Private Letter Ruling No. 8453015

In a recent Private Letter Ruling, the IRS determined that a taxable electric cooperative was not a regulated public utility and was thus entitled to depreciate its assets using the five-year rather than the fifteen-year ACRS tables. Additionally, the IRS determined that the electric cooperative would not be barred from taking energy tax credits on specific assets to the extent otherwise available. The IRS reasoned that the "public utility" status of an electric cooperative was not dependent upon whether the cooperative's rates were regulated, but rather on whether those rates were regulated on a "rate of return basis." As a result, depending upon the nature of the state rate regulation, the applicability of the principles set forth in this letter ruling may vary.

B. Private Ruling (TAM) 8404009 Technical Advice Memorandum

The IRS issued a technical advice memorandum on the issue of whether interest earned on the temporary investment of pollution control bond proceeds could be offset against interest paid with only the balance capitalized to the plant account. The IRS held that because the taxpayer elected to capitalize interest and carrying charges during construction it had to do so without offset. Accordingly, the intererst earned on the investment of the bond proceeds was fully taxable.

C. Private Letter Ruling No. 8429025

In a recent Private Letter Ruling issued to an electric cooperative, the IRS held that a lignite-fired generation station was "in service" for purposes of depreciation and tax credits notwithstanding the fact that testing would continue after the in-service date, that no sales of power were made from the plant, and that the company intended to defer operation of the plant until an unspecified time in the future. The IRS essentially determined that the plant was placed "in service" when first synchronized during testing. In support of this conclusion, the IRS relied upon Treas. Reg. § 1.46-3(d) which states that property will be considered in service when it is "placed in a condition or state of readiness and availability for a specifically assigned function." The effect of this ruling on the electric industry may be significant. Where an asset is tested and shown to be operational, the asset may be considered in service for tax purposes although not currently needed.

D. Private Letter Ruling No. 8351058

In this ruling, the IRS determined that the two-county rule applicable to industrial development bonds must be applied by reference to the entire output of a generating facility, and that a utility that only served a two-county area could not rely on this exception to finance its share of a large facility that would serve a much larger area.

E. Private Letter Ruling No. 8418047

The IRS determined that a solar electric generating system consisting of parabolic trough collectors, pipes, storage tanks, heat exchange, and related equipment qualified for the credit as solar electric generating equipment.

F. *Private Letter Ruling No. 8442056*

In this ruling, the IRS determined that an ethanol plant qualified as biomass property. The primary energy source for the facility was electricity purchased from an electric cooperative which produced 98 percent of its electricity from coal.

G. *Revenue Ruling No. 84-134*

In this revenue ruling, the IRS clarified its position relating to the recapture of ITCs when a taxpayer elects to defer recognition of gain from reacquisition of debt at less than face value by reducing the basis of the ITC qualified property. Under the revenue ruling, there is no recapture of ITCs and corresponding increase in federal income tax liability when a taxpayer elects to reduce the basis of ITC qualified property rather than recognize the gain arising from reacquisition of bonds at less than face value on discharge of indebtedness.

V. Changes in Tax Laws

In addition to the changes in the tax laws outlined in the last Committee Report that affect oil and gas producers, the Deficit Reduction Act of 1984 ("DEFRA") contains other provisions that may significantly affect the energy industry. For example, natural gas companies may receive refunds from their suppliers for amounts that have been overcharged. These refunds are generally made to utilize pursuant to regulatory commission orders and must be passed through to customers. Rev. Pub. 63-182, 1963-2 C.B. 194, which interprets the "all events test" under prior law, permits a utility to deduct the amounts refunded to customers in the year the refunds are received by the utility, rather than the year the refunds are passed through to customers.

Under section 91 of DEFRA, the all events test for a taxable year is met if economic performance occurs within the shorter of a reasonable period after the close of the taxable year or 8½ months after the close of the taxable year. Congress intended that the Treasury Department have the authority to provide that a utility may deduct the refunds in the year the refund is included in the income of the utility, provided that the refunds are passed through to customers within a reasonable period of time in the following taxable year, and that interest is paid over to and includible in the income of the customers.

Other provisions of DEFRA that generally affect the energy industry include:

(1) *Accrual Method of Accounting* — DEFRA requires that economic performance must occur before "all events" establishing the fact of liability will be deemed to have occurred. As a general rule, "economic performance" occurs when the activities that must be performed to satisfy a liability are in fact performed. There are exceptions. For example, the requirement does not apply to a liability to provide benefits to employees under qualified pension and profit sharing plans. That is, deductions continue to be allowed when contributions are made to the plan.

(2) *Tax Exempt Bonds* — DEFRA requires the economic accrual of the original issue discount ("OID") on tax-exempt bonds. OID is apportioned on a straight-line method over the term of the obligation and this amortization cannot be used to create an artificial loss. Only economic losses will be realized upon early disposition.

(3) *Exchange of Debts for Stock* — Under DEFRA, a corporation that issues stocks in cancellation of its debts will recognize income to the extent the principal of the debt exceeds the value of the stock.

(4) *Consolidated Returns* — DEFRA restructures the definition of an affiliated group for income tax purposes. Under the Act, two corporations are ineligible to file a consolidated return unless, at the beginning of the year, one of the corporations owns stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of the fair market value of the outstanding stock of the other corporation.

(5) *State Cap in IDB's and Straight-Line Depreciation on IDB-Financed Property* — Under DEFRA, each state is limited as to the amount of tax-exempt "private activity bonds" it and its localities may issue in a given year to the greater of $200,000,000 or the product of $150 times the state population. The Act also provides for straight-line depreciation for sewage and solid waste facilities and pollution control facilities installed in connection with existing plants that are financed with exempt bonds. The volume cap may limit the availability of tax-exempt pollution control financings.

(6) *Tax-Free Dividend Reinvestment Plans (DRIP)* — DEFRA retains DRIP through 1985.

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