

Report of the Committee on Tax Developments

I. INTRODUCTION

For the most part, 1988 was a year of tax law adjustments rather than major changes. There were no major, substantive tax bills enacted by the 100th Congress in 1988. The most significant legislative change was the repeal of the windfall profit tax by the Omnibus Trade and Competitiveness Act of 1988 (Trade Act).¹ Other 1988 legislation affecting federal taxation of energy firms was the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).² The Internal Revenue Service (Service or IRS) adopted two sets of final regulations in 1988 that directly affect energy firms. The regulations concerned (1) the windfall profit tax and (2) deductible contributions to nuclear power plant decommissioning funds. Most of the energy taxation activity concerned interpretive rulings and court cases, rather than legislative or regulatory actions.

II. DEVELOPMENTS AFFECTING THE OIL, GAS AND COAL INDUSTRIES

A. *Crude Oil Windfall Profit Tax*

1. Legislative Developments: Repeal of Windfall Profit Tax

In 1988, Congress repealed the windfall profit tax. Congress recognized that the tax no longer generated significant revenue from the distressed oil industry, but imposed excessive administrative and reporting costs on oil producers.³ Under section 1941 of the Trade Act⁴, the windfall profit tax will no longer apply to crude oil removed or deemed removed from producing premises on or after August 23, 1988. However, the tax will continue to apply to oil removed or treated as removed before August 23, 1988 (pre-repeal oil). The application of the windfall profit tax to pre-repeal oil will be of little economic significance for oil recently produced because the tax generally applies to revenues received in excess of certain "adjusted base prices," and the market price has not recently exceeded these base levels. Production in earlier years will typically be protected by the three-year limitation period on assessments. However, any producer who has entered into a Form 872 agreement with the IRS extending the usual three-year limitation period may be able to file a meaningful claim for refund and, similarly, could receive a deficiency notice for underpaid windfall profit tax in earlier years. The regulations, cases and rulings on windfall profit tax discussed in the following sections will be of interest to such producers.

After Congress repealed the windfall profit tax in the Trade Act, it became apparent that producers who owed no tax in 1988 could still be required to incur the costly burden of filing windfall profit tax reports. Con-

1. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (1988).
2. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).
3. See, e.g., 133 CONG. REC. S9796, S9843-44 (daily ed. July 14, 1987) (statement of Sen. Wallop).
4. Pub. L. No. 100-418, § 1941, 102 Stat. 1107, 1320-22 (1988).

gress attempted to correct this problem in section 6254 of the TAMRA,⁵ by repealing the reporting requirements of former Internal Revenue Code (Code) section 4997 and voiding related IRS regulations with respect to crude oil removed on or after January 1, 1988. A taxpayer will not be subject to reporting requirements for oil produced between January 1, 1988, and August 23, 1988, if the taxpayer reasonably believes that no windfall profit tax accrued during 1988 with respect to such crude oil, and there was no windfall profit tax withheld for such oil.⁶ This legislative change supersedes I.R.S. Notice 88-115.⁷

2. Windfall Profit Tax Regulations

Before Congress repealed the windfall profit tax, the IRS issued final regulations to provide guidance concerning the qualification of crude oil as "newly discovered oil," and the definition of production in "commercial quantities" for purposes of the net income limitation on windfall profit.⁸ The regulations still affect all crude oil removed or deemed removed between February 20, 1980 and August 23, 1988, the effective date of the windfall profit tax repeal.

3. Cases and Rulings Applicable to Pre-Repeal Oil

In *Shell Oil Company v. Commissioner*,⁹ the Tax Court held that, for purposes of determining the windfall profit tax net income limitation, interest which has accrued on unsecured debt constitutes general corporate overhead and may be allocated to all of the taxpayer's activities, including producing properties. In footnote 3, the court held that the proper period for determination of a deficiency in windfall profit tax was the calendar year. The Service filed a motion for reconsideration of the footnote 3 holding, and on reconsideration, the court amended its earlier opinion and stated that the calendar quarter, rather than the calendar year, was the proper taxable period to be used for determining a deficiency in windfall profit tax of a producer of oil not subject to withholding.¹⁰

In *Natomas North America, Inc. v. Commissioner*,¹¹ the Tax Court held that the 1980 implementation of a plan to increase flue gas injection qualified as a post-May 1979 "significant expansion" within the meaning of section 4993(d)(4) of the Code. Therefore, the oil removed from the field qualified as incremental tertiary oil under Code section 4993 and Tier 3 oil for purposes of the windfall profit tax.

5. Pub. L. No. 100-647, § 6254, 102 Stat. 3342, 3753 (1988).

6. H.R. CONF. REP. NO. 1104, 100th Cong., 2d Sess., 134 CONG. REC. H10867, H11066 (daily ed. Oct. 21, 1988).

7. I.R.S. Notice 88-115, 1988-43 IR-14 (Oct. 11, 1988).

8. T.D. 8185, 53 Fed. Reg. 6626-28 (March 2, 1988).

9. *Shell Oil Co. v. Commissioner*, 89 T.C. 371 (1987), *amended on reconsideration*, 90 T.C. 747 (1988).

10. *Shell Oil Co. v. Commissioner*, 90 T.C. 747 (1988).

11. *Natomas N. Am. v. Commissioner*, 90 T.C. 710 (1988).

In *Exploration Company v. United States*,¹² a U.S. District Court held that a corporate taxpayer did not qualify for reduced windfall profit tax rates for its 1983 Tier 1 production or a stripper well exemption for its 1983 Tier 2 production because the oil was not attributable to a taxpayer's working interest in existence on January 1, 1980. As a result, the produced oil was not "independent producer oil."

This term, the U.S. Supreme Court will consider whether a state may include income derived from out-of-state activities as taxable income for a multistate pipeline corporation, and at the same time, prohibit the deduction of federal windfall profit tax incurred solely as a result of such income.¹³

B. Deductions & Exclusions

1. Intangible Drilling & Development Costs

In Revenue Ruling 88-10,¹⁴ the Service ruled that under Code section 263(c), a taxpayer, at his option, can deduct the costs of drilling expendable holes from mobile drilling rigs to find off-shore oil and gas deposits, even though the taxpayer intended only to determine the extent and configuration of oil and gas deposits and had no intention to complete them as producing wells. Under the relevant case law, the Service reasoned that regardless of whether the taxpayer intended to produce hydrocarbons, the bore holes qualified as "wells" within the meaning of section 263(c), because they were capable of conducting or aiding the conduction of hydrocarbons to the surface. The off-shore holes had the same diameters as those which would be drilled for the purpose of completing producing wells.

In *McGarvie v. Commissioner*,¹⁵ drilling was performed by a promoter/operator as a package deal. Accordingly, the deduction claimed by investors could not exceed what would have been charged by an independent contractor under an arms-length drilling contract. The taxpayers apparently were unable to produce any convincing evidence of what an arms-length amount would be. The court, however, relying on the *Cohan* rule,¹⁶ stated that it would determine a reasonable amount on its own and allow a deduction for the amount so determined.

2. Depletion Deduction

In *Ray H. Potts v. Commissioner*,¹⁷ the Tax Court held that the applicable independent producer and royalty owner oil and gas percentage depletion rate was to be determined by reference to the year in which gross income from the oil is reported, even though the production occurred in an earlier tax year. Thus, where a taxpayer extracted oil and gas in 1981, but did not report the

12. *Exploration Co. v. United States*, 672 F. Supp. 258 (W.D. La. 1987).

13. See *Amerada Hess Corp. v. Director*, 107 N.J. 307, 526 A.2d 1029 (N.J. 1987); *Texaco, Inc. v. Director*, 107 N.J. 307, 526 A.2d 1029 (N.J. 1987), *jur. noted*, 108 S. Ct. 1726 (1988); 41 TAX NOTES 65, 66 (Oct. 3, 1988).

14. Rev. Rul. 88-10, 1988-6 I.R.B. 5 (1988).

15. *McGarvie v. Commissioner*, 57 T.C.M. (P-H) 1988-85 (1988).

16. See *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

17. *Ray H. Potts v. Commissioner*, 90 T.C. 995 (1988).

related gross income until 1982, the taxpayer was entitled to depletion only at the eighteen percent rate available in 1982, and not at the twenty percent rate for 1981 oil.

In Private Letter Ruling 88-20-001,¹⁸ the Service considered whether gas producers who sold natural gas under fixed contracts in effect on February 1, 1987, would qualify for the exception from the partial repeal of percentage depletion. The Service found that a contract is "fixed" if the price paid for gas may not be changed to reflect the seller's increased tax liabilities resulting from the repeal of percentage depletion. The landowner in question was entitled to receive a royalty share of natural gas produced on his property under several different formulas, including one wherein the weighted average price paid in the area for natural gas purchased for resale by three principal pipelines was used. The Service determined that this price would reflect the fair-market value of gas and would compensate the taxpayer for increased tax liabilities occasioned by the repeal of percentage depletion, and therefore, the gas was not sold at a fixed price.

3. Nonconventional Fuel Credit—Code Section 29

a. Legislative Developments

(1) One Year Extension of Placed-In Service Rule

TAMRA section 6302¹⁹ amends Code section 29²⁰ to provide a one-year extension of the placed-in service rule.

(2) Carryover Allowed Under Minimum Tax

TAMRA section 6304²¹ amends Code section 53²² to provide that the credit for prior year minimum tax liability will be increased by the amount of the nonconventional fuels credit not allowed solely due to the application of section 29(b)(5)(B).

b. Cases and Rulings on the Fuel Credit

The availability of the section 29 tax credit for "tight formation gas" has been curtailed substantially by the U.S. Supreme Court's decision in *FERC v. Martin Exploration Management Company*.²³ The *Martin Exploration* opinion addresses the issue of whether "new tight formation gas" continues to be regulated under the Natural Gas Policy Act of 1978 (NGPA).²⁴ Deregulation under the NGPA is provided for in section 121. That section provides that the price of NGPA section 102(c) gas, as well as certain section 103(c) gas, shall be deregulated on and after July 1, 1987. Although Congress also

18. Priv. Ltr. Rul. 88-20-001 (Feb. 5, 1988).

19. Pub. L. No. 100-647, § 6302, 102 Stat. 3342, 3755 (1988).

20. I.R.C. § 29 (1982 & Supp. 1986).

21. Pub. L. No. 100-647, § 6304, 102 Stat. 3342, 3756 (1988).

22. I.R.C. § 53 (1982 & Supp. 1986).

23. *FERC v. Martin Exploration Mngmt. Co.*, 56 U.S.L.W. 4458 (May 31, 1988).

24. National Gas Policy Act of 1978, 15 U.S.C. §§ 3301-432 (1982 & Supp. 1986).

deregulated section 107(c)(1)-(4) gas, it did not expressly deregulate the price of section 107(c)(5) gas, which includes tight formation gas. However, the Federal Energy Regulatory Commission (FERC), in promulgating regulations to implement deregulation, determined that where gas qualified both as new tight formation gas and as a type of gas for which prices were deregulated under NGPA section 121, the price for such gas would be deregulated.²⁵

Thus, under NGPA section 121, as construed by FERC and the Supreme Court, dually-qualified new tight formation gas is no longer subject to a price "which is regulated by the United States," and thus is no longer eligible for a tax credit under section 29 of the Code. The Service reached this same conclusion in a 1986 revenue ruling.²⁶ After *Martin Exploration*, only those types of tight sands gas whose prices have not been deregulated, such as "recompletion" tight formation gas, are still eligible for a section 29 tax credit.

In Private Letter Ruling 88-36-071,²⁷ the Service considered whether the section 29 credit applied to liquid and solid products produced from a sub-bituminous coal feed stock by a process which caused a chemical and physical restructuring of the feed stock. The Service held that the products fell within the definition of qualified fuels, that is "liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feed-stocks." Accordingly, the taxpayer qualified for a section 29 credit for producing fuels from a nonconventional source.

In Private Letter Ruling 88-48-001,²⁸ the Service ruled that the receipt of a determination under NGPA section 503 stating that gas is produced from Devonian shale or a tight formation, is *not* required prior to taking a credit for producing fuel from a nonconventional source under Code section 29. The Service reasoned that there was no evidence in the legislative history of Code section 29 that Congress intended to impose such a requirement.

Code section 29(f)(1)(A)(i) provides that the credit generally will apply to qualified fuels that are "produced from a well drilled after December 31, 1979, and before January 1, 1990."²⁹ In Private Letter Ruling 88-45-015,³⁰ the Service ruled that for purposes of this rule, a well is determined to be drilled on the date that the well is spudded.

4. Alcohol Fuel Income Tax Credit—Code Section 40³¹

Revenue Ruling 88-64³² considered the applicability of the credit under Code section 40. The issue was whether the taxpayer produced a "qualified

25. [Reg. Preambles 1982-1985] F.E.R.C. ¶ 30,614, at 31,229 (1984).

26. Rev. Rul. 86-127, 1986-2 C.B. 4, *modifying and superseding* Rev. Rul. 86-19, 1986-1 C.B. 4.

27. Priv. Ltr. Rul. 88-36-071 (June 17, 1988).

28. Priv. Ltr. Rul. 88-48-001 (June 30, 1988).

29. I.R.C. § 29(f)(1)(A)(i) (1982 & Supp. 1986).

30. Priv. Ltr. Rul. 88-48-015 (Aug. 30, 1988).

31. I.R.C. § 40 (1982 & Supp. 1986).

32. Rev. Rul. 88-64, 1988-32 I.R.B. 5.

mixture" as that term is defined in section 40(b)(1)(B) of the Code. In the first situation, the taxpayer acquired the proper components and mixed them to form the product which he then blended with gasoline to create a mixture of one part product and nine parts gasoline. This product possessed an alcohol content of 2.5%. The product was then sold to a distributor who sold it to a service station which then sold the product as fuel to consumers. In the second situation, the same product was stored at a terminal for sale to buyers. Buyers sent tanker trucks containing their own gasoline to the terminal where the product was delivered into the tanker trucks in the proper proportion, one part product to nine parts gasoline. The buyer then sold the product to distributors who in turn sold it to service stations for sale to customers. The Service held that the producers of the product did not have to sell directly to the end user, but it was sufficient that the product ultimately was resold to such users. In the second situation, the credit was denied because the taxpayer sold the product to another for further blending and this party would be considered the producer of the qualified mixture.

C. Mineral Interests and Royalties

1. Advanced Royalty—Substantially Uniform Payments

The Ninth Circuit recently affirmed the Tax Court's decision in *Heitzman v. Commissioner*³³ which held that a partner may not deduct his share of the partnership's obligations for advanced minimum oil and gas royalties and drilling costs. The Ninth Circuit held that there must be an enforceable obligation to make substantially uniform minimum royalty payments each year in order to satisfy Treasury Regulation section 1.612-3(b)(3).³⁴

2. Wildcat Lease Assignment

In *Watnick v. Commissioner*,³⁵ the Tax Court sustained the Service's deficiency determination, agreeing with the Service that payments received by Watnick for assignment of a wildcat oil and gas lease to Exxon were advanced royalty payments taxable as ordinary income subject to depletion.

D. Tax Shelters

In *Hawley v. Commissioner*,³⁶ the Tax Court held that taxpayers who invested in coal leasing limited partnerships were not allowed to deduct their share of losses due to advance royalty payments, because the transactions had no economic substance.

In *Smith v. Commissioner*,³⁷ the Tax Court examined certain limited partnerships that were formed to exploit the "Koppelman Process," a process which refines wood, peat, lignite and other low-grade biomass or fossil fuel

33. *Heitzman v. Commissioner*, 56 T.C.M. (P-H) 1987-109 (1987), *aff'd*, 859 F.2d 783 (9th Cir. 1988).

34. *Heitzman*, 859 F.2d 784-86.

35. *Watnick v. Commissioner*, 90 T.C. 326 (1988).

36. *Hawley v. Commissioner*, 57 T.C.M. (P-H) 1988-77 (1988).

37. *Smith v. Commissioner*, 91 T.C. 733 (1988).

into "K-Fuel," a dry, stable solid fuel with a higher heating value. The Tax Court questioned whether the Koppelman Process had any economic substance and held that the partnerships were not a trade or business, and therefore, the limited partners could not deduct related research and development expenses.

E. State Taxation

1. Legislative Developments: Proposed Federal Legislation to Limit State Property Taxation of Pipelines

H.R. 2953, introduced by Rep. William J. Hughes in the last session, would limit the power of states to levy *ad valorem* taxes on interstate natural gas pipeline property. The measure was defeated in the House on October 6, 1988,³⁸ but Rep. Hughes plans to reintroduce the bill in the next Congress.

2. Cases: State Income Taxation of Outer Continental Shelf Oil

In *Shell Oil Company v. Iowa Department of Revenue*,³⁹ the United States Supreme Court held that a state may include as part of its corporate income tax base under a properly apportioned corporate income tax, income earned from oil and gas extraction on the outer continental shelf. The taxpayer had argued that certain provisions of the Outer Continental Shelf Lands Act (OCSLA) prohibited such state taxation. Specifically, the taxpayer noted that while OCSLA adopted as federal law the criminal and civil law of the adjacent states, it included the proviso that state taxation laws should not apply to the outer continental shelf, and that the adoption of state laws as the law of the U.S. "shall not be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any state over the outer continental shelf . . . or the revenues therefrom."⁴⁰ The Court rejected this argument, finding that OCSLA did not preclude any state from including income earned from the sale of oil and gas extracted from the outer continental shelf in its properly apportioned corporate income tax. The Court limited the qualifying exceptions in OCSLA to taxes based on territorial jurisdiction, such as severance or other direct taxes, holding that an apportioned income tax was not such a tax.

III. REGULATED ELECTRIC AND GAS UTILITIES

A. Normalization and Other Tax Accounting Matters

1. Legislative Developments

On February 9, 1988, Congressman Byron L. Dorgan introduced H.R. 1049, the Utility Ratepayer Refund Act, which would give state utility commissions the authority to determine how and when utilities should return excess deferred taxes to their ratepayers. Dorgan plans to reintroduce the bill in the next Congress. The Reagan Administration had strongly opposed the

38. 134 CONG. REC. H9775 (daily ed. Oct. 6, 1988).

39. *Shell Oil Co. v. Iowa Dep't of Rev.*, ___ U.S. ___, 109 S. Ct. 278 (1988).

40. *Id.* at 281.

bill.⁴¹

At Dorgan's request, the General Accounting Office (GAO) studied the speed with which electric utilities should be required to repay to their ratepayers taxes that are no longer owed to the federal government due to the reduction of corporate tax rates by the Tax Reform Act of 1986 (TRA).⁴² In a January 1988 report, the GAO concluded that such a determination should be made on a case by case basis.⁴³ The GAO is preparing similar reports on the telephone and natural gas industries.⁴⁴

2. Cases and Rulings on Normalization

In Revenue Ruling 87-137,⁴⁵ the Service ruled that a public utility cannot continue to use accelerated depreciation on post-1969 property if, under the grandfathering provision in section 167(1)(2)(C),⁴⁶ the utility had been eligible to use flow-through but instead adopted normalization and only later reverted to flow-through as to property placed in service before January 1, 1981. In making its analysis, the Service looked to the Senate Committee Report relevant to section 167(1)(2)(C). The Service noted that the committee had stated that, except where a utility presently uses flow-through and is allowed to continue to use accelerated depreciation, accelerated depreciation is to be permitted only if the utility normalizes deferred income taxes. The Service stated

[that in light] of the legislative history of section 167(1) of the Code and the regulations issued thereunder, it is clear that section 167(1)(2)(C) is a grandfathering provision that allows utilities that were already using flow-through accounting and accelerated depreciation to continue to do so [O]nce a utility has shifted to normalization accounting, there is no longer any reason to grandfather that taxpayer. Section 167(1)(2)(C) was intended to avoid tax-imposed discontinuity in regulatory accounting, and it would not further that purpose for the section to apply to a taxpayer that shifted independently from flow-through to normalization.⁴⁷

In Revenue Ruling 87-139,⁴⁸ the Service ruled that the excess reduction rule under section 203(e) of the TRA applies to taxpayers that voluntarily adopted a normalization method of accounting in the same manner as it does to taxpayers to whom either section 167(1)(2)(C) of the Code never applied or, as a result of an election under section 167(1)(4)(A), section 167(1)(2)(C) no longer applies. In its analysis in Revenue Ruling 87-139, the Service relied on Revenue Ruling 87-137, and declared that the requirements of section 203(e) of the TRA should be applicable to excess deferred reserves, even though the reserves resulted from the voluntary adoption of a normalization method of accounting that was not required under the Code at the time of the adoption.

41. See DAILY TAX REP. (BNA) at G-2 (Jan. 21, 1988).

42. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

43. See DAILY TAX REP. (BNA) at G-1, G-2 (Jan. 21, 1988) (discussing *Public Utilities: Information on the Cash Position of the Electric Utility Industry* (GAO/RCED 88-76)).

44. *Id.*

45. Rev. Rul. 87-137, 1987-2 C.B. 64.

46. I.R.C. § 167(1)(2)(C) (1982 & Supp. 1986).

47. Rev. Rul. 87-137, 1987-2 C.B. 64, 65.

48. Rev. Rul. 87-139, 1987-2 C.B. 65.

Making available an exception to the general rule of Revenue Ruling 87-139, the Service issued Revenue Procedure 88-12,⁴⁹ which provides a method for reducing the excess reserve for certain public utility taxpayers, pursuant to TRA section 203(a). Because a regulatory agency has required them to compute depreciation on public utility property based on an average life or composite rate method, rather than a vintage account method, these taxpayers are unable to use the average rate assumption method. Revenue Procedure 88-12 applies only to utilities whose books and underlying records do not contain the vintage account data necessary to apply the average rate assumption method.

By its own terms, Revenue Procedure 88-12 is further limited to those using the Reverse South Georgia Method under which a utility: "(a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property."⁵⁰

In two private letter rulings the Service determined⁵¹ that a natural gas pipeline company's adoption of the FERC's RSGM satisfied the normalization requirements of TRA section 203(e). In both cases, the pipeline company maintained no vintage accounts and complied with Revenue Procedure 88-12. Each pipeline had used accelerated depreciation since 1955. As a result of FERC's imposition of composite accounting on the pipelines, the FERC staff had advocated a method of reducing the company's excess tax reserve by use of the RSGM. Under the RSGM, the excess deferred tax account would be amortized and would flow back to the customers in equal increments beginning July 1, 1987, and continuing during the remaining depreciable book life of each company's assets on a composite basis for the company's net book plant as of June 30, 1987.

In *Public Utility Commission v. FERC*,⁵² the D.C. Circuit remanded for FERC's consideration whether the excess accumulated deferred tax reserve that resulted from switching from cost of service pricing to NGPA pricing should inure to the benefit of future or past customers.

In Private Letter Rulings 88-41-009 and 88-37-049,⁵³ the Service ruled that a method used to calculate the allowance for funds used during construction (AFUDC) that assigns a cost rate of zero to funds generated from investment tax credits does not violate normalization requirements. The Service observed that AFUDC is not a cost supported by investment tax credit (ITC) and is not a rate base component supported by ITC. The Service noted that regulators can determine whether to charge AFUDC and how it should be treated in rate base. Thus, the Service reasoned, any method used to arrive at a ratio or percentage for capitalizing the cost of funds is inherently independent of any Code-required ratemaking treatment of ITCs. The Service con-

49. Rev. Proc. 88-12, 1988-8 I.R.B. 15.

50. Rev. Proc. 88-12, 1988-8 I.R.B. 15, 16.

51. Priv. Ltr. Rul. 88-25-032 (Mar. 22, 1988); Priv. Ltr. Rul. 88-25-035 (Mar. 22, 1988).

52. *Public Util. Comm'n v. FERC*, 817 F.2d 858 (D.C. Cir. 1987).

53. Priv. Ltr. Rul. 88-41-009 (July 13, 1988); Priv. Ltr. Rul. 88-37-049 (June 20, 1988).

cluded that section 46(f) does not apply to a proposal to calculate AFUDC in a given way.

In Private Letter Ruling 88-36-052,⁵⁴ the Service ruled that a regulatory commission's method of establishing cost of service by using a forty percent tax rate while reducing the rate base with an accumulated deferred income tax (ADIT) reserve calculated at forty-six percent does not violate normalization requirements. The Service emphasized that the actual federal income tax rate during the test period had been forty-six percent and that the rates the utility actually charged its customers during the test period "had been set in a previous rate case to cover a level of Federal income tax expense which had been calculated using the actual Federal income tax rate of 46 percent."

The utility had wanted to adjust its ADIT balance to reflect the level of ADIT that would have existed at the end of the test period if the deferred income taxes added to the reserve during the test period had been computed at forty percent rather than forty-six percent (as had been the case). The regulatory commission had disagreed with the utility and used the actual ADIT balance in computing the utility's rate base.

In Private Letter Ruling 88-34-032,⁵⁵ the Service ruled that the normalization requirements of section 167(1) do not apply to timing differences due to the use of the percentage repair allowance because such deferred taxes do not relate to the use of different methods of depreciation. Furthermore, the Service ruled, an immediate flowback to retail ratepayers of deferred taxes attributable to the percentage repair allowance does not cause a violation of the normalization provisions under section 203(e) of the TRA, because the property at issue was placed in service prior to 1980. The timing difference had occurred because the utility had used the percentage repair allowance to claim current deductions for tax purposes but had not claimed the deductions for financial accounting purposes.

In Private Letter Ruling 88-25-011⁵⁶ the Service ruled that an electric utility's plan to phase the cost of an operating nuclear unit into its rate base over three years, rather than all at once, met the normalization requirements of Code sections 46(f)(2) and 168(e)(3). When a utility and its parent corporation began commercial operation of one of the units of a nuclear plant, the parent elected, under section 46(d)(6), to claim ITCs on qualified progress expenditures related to its share of the construction of some of the plant's units. The parent proposed to phase the operating unit into the rate base and in accounting for depreciation for ratemaking purposes, depreciation was to be expensed only on the costs that were included in the rate base.

Under the phase-in plan, the investment credits were not to affect the parent's rate base, thereby ensuring compliance with section 46(f)(2)(B). The Service determined that the utility's parent company would use the same estimates and projections in calculating depreciation expense, tax expense,

54. Priv. Ltr. Rul. 88-36-052 (June 15, 1988).

55. Priv. Ltr. Rul. 88-34-032 (May 26, 1988).

56. Priv. Ltr. Rul. 88-25-011 (Mar. 14, 1988).

deferred taxes, and its rate base, thus ensuring the consistency required for the normalization method.

B. Deductions and Exclusions

1. Contributions in Aid of Construction

An I.R.S. Notice issued on December 27, 1988,⁵⁷ has provided important guidance on the treatment of payments associated with transfers of interconnection equipment to regulated public utilities by qualifying small power producers and qualifying cogenerators (QFs). The TRA repealed the exclusion from income under Code section 118 for contributions in aid of construction (CIAC) paid to regulated utilities. Before this repeal, many utilities had treated QF interconnection transfers as excludable CIAC. After the repeal, they began to require QFs to pay, in addition to interconnection costs, a *gross-up* to cover the utility's potential increased tax liability. I.R.S. Notice 88-129⁵⁸ clearly states that payments or transfers designed solely to facilitate the sale of electricity by a QF to a utility will not result in a taxable CIAC. The Service reasoned that such transactions are distinguishable from taxable CIAC's which are entered into to facilitate the sale of power by the utility to a customer. Notice 88-129 further provides that where an interconnection is used by a QF for both power purchases and sales, the interconnection equipment will be treated as a facility used exclusively to sell power to the utility, so long as no more than five percent of the power which flows through the interconnection is generated by the utility.

I.R.S. Notice 87-82,⁵⁹ also provides guidance on the nature of the transactions which will qualify as excludable CIAC under Code section 118(a) after the TRA. In broad terms, the Notice indicates that amounts received by utilities for relocating utility facilities will be includable in income if such payments appear to be consideration for the provision of future services. More specifically, amounts received as a condition of service which will benefit the party making the payment to the utility do not constitute CIAC excludable from income under section 118(a). Alternatively, amounts received under a government program that are not for the direct benefit of particular customers of the utility in their capacity as customers are excludable from income. Where property transfers are includable in income, Notice 87-82 indicates that, absent abnormal circumstances, the value of such property is equal to its replacement costs.

Under Notice 87-82, the service will look to the substance of a transaction to determine if a CIAC has been made. A CIAC will be deemed to have been made if a utility assumes the benefits and burdens commonly associated with ownership of the property without fully compensating the transferee.

Notice 87-82 also indicates that CIAC property is subject to the normalization rules of sections 167 and 168 of the TRA. In those instances where the utility does not record the CIAC as an asset, the utility will be deemed to have

57. I.R.S. Notice 88-129, 1988-52 I.R.B. 10.

58. *Id.*

59. I.R.S. Notice 87-82, 1987-2 C.B. 389.

depreciated the CIAC in its entirety in the year of receipt. This treatment will result in a reduction of the reserve for deferred taxes to reflect the fact that the property is being depreciated more rapidly on the utility's account books than for tax purposes. Alternatively, the notice provides that the normalization rules will not apply under certain conditions where the contributor reimburses the utility for the tax imposed upon the CIAC. The conditions are: (1) the CIAC is taxable solely by reason of the amendment to section 118(b); (2) the utility does not record the CIAC as an asset; (3) the tax attributable to the CIAC is not included in the cost of service used to set rates for persons other than the contributor; and (4) the contributor pays the utility an amount reasonably intended to reimburse the utility for the tax attributable to the CIAC.

Private Letter Ruling 88-31-002⁶⁰ further restricted the scope of the section 118 exclusion by revoking a prior private letter ruling holding that certain payments related to the purchase of utility services constituted a CIAC excludable from income. The facts indicated that the payments were reimbursements made by a governmental agency to a taxpayer that owned a single generating plant and provided service exclusively to the governmental agency.

In its analysis, the Service indicated that for the years in question, the exclusion under former section 118(b)(1) of the Code was limited to "money or property received from any person (whether or not a shareholder) by a regulated public utility. . . ."⁶¹ and that under section 118(b)(1)(C) the term "regulated public utility" was limited to a utility required to provide electric energy services to members of the general public in its service area. Based upon the terms of the taxpayer's sales contracts, the Service found that it was not reasonable to expect that service would be provided to the general public. Accordingly, the Service ruled that the taxpayer did not meet the definition of a "regulated public utility" contained in former section 118(b)(3)(C) of the Code and that the payments were not eligible for exclusion from gross income under section 118(b).

In addition, the Service found that the facts presented failed to meet the Supreme Court's two basic tests for an exempt CIAC. First, the payment did not arise from a motivation other than compensation, as required by *Commissioner v. Detroit Edison Company*,⁶² and *Brown Shoe Company v. Commissioner*.⁶³ Second, the payment did not have the required economic effect on the transferee, because it did not materially contribute to the production of additional income and therefore did not satisfy the test of *United States v. Chicago Burlington & Quincy Railroad*.⁶⁴ Accordingly, the Service found that the payment was not excludable from income under section 118(a).

2. Customer Deposits and Surcharges

An excellent discussion of recent case law in this area has been compiled wherein it is stated:

60. Priv. Ltr. Rul. 88-31-002 (Apr. 23, 1988).

61. *Id.*

62. *Commissioner v. Detroit Edison Co.*, 319 U.S. 98 (1943).

63. *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950).

64. *United States v. Chicago Burlington & Quincy R.R.*, 412 U.S. 401 (1973).

The Tax Court has long recognized the subtle distinctions between deposits that serve as security for performance under a contract, but are not income, and advance payments of income, generally taxed in the year of receipt. However, the Tax Court has experienced some problems reconciling its views with those of the courts of appeals.⁶⁵

In *Indianapolis Power & Light Company v. Commissioner*,⁶⁶ the Tax Court held that a utility's gross income does not include deposits collected from its customers that fail to meet standardized credit worthiness requirements established by a regulatory commission. Because the facts showed that the customer retained control over the deposit, the Tax Court did not apply the primary purpose test of *City Gas Company v. Commissioner*.⁶⁷ The Seventh Circuit affirmed, holding that the deposits were excludable security deposits.

The Tax Court also held in *American Telephone & Telegraph Co. (AT&T)*,⁶⁸ that utility customer deposits were excludable security deposits. The AT&T deposits were similar to those examined in *Indianapolis Power*, with one notable addition. Under the terms of the deposit agreement, AT&T usually would refund a security deposit if a customer paid his monthly bills on time for one year, thereby demonstrating the customer's credit worthiness.

In *Electric Energy, Inc. v. United States*,⁶⁹ the Claims Court found that surcharges paid by the Department of Energy to a utility were not includable in the utility's gross income in the year received because they were simply held in trust to indemnify the utility's owners for previously incurred costs.

In *Iowa Southern Utilities Company v. United States*,⁷⁰ the Court of Claims held that surcharges used to finance an electric power plant were not loans and were not includable in income upon receipt because: (1) they were available for general use and were not segregated and (2) no interest was payable when the surcharges were refunded and the surcharges were treated as payments for electricity and sales tax.

3. Abandonment Loss

In Revenue Ruling 87-117,⁷¹ the Service permitted a utility to deduct the cost of an abandoned, partially constructed nuclear power plant under Code section 165(a) even though the regulatory commission having jurisdiction over the utility and had granted the utility a rate increase.

The Service applied Revenue Ruling 87-117 in Private Letter Ruling 88-50-016,⁷² holding that the abandonment of a nuclear power plant could be deductible even when the utility was earning a return on a contemporaneously

65. Seago, *Recent Cases Focus on When Deposits Are Includable in Income*, 70 J. TAX'N 38 (1989).

66. *Indianapolis Power & Light Co. v. Commissioner*, 88 T.C. 964 (1987), *aff'd*, 857 F.2d 1162 (7th Cir. 1988).

67. *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982).

68. *American Tel. & Tel.*, 55 T.C.M. (CCH) 16 (1988).

69. *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644 (Cl. Ct. 1987).

70. *Iowa Southern Utils. Co. v. United States*, 11 Cl. Ct. 868 (Cl. Ct. 1987), *aff'd*, 841 F.2d 1108 (Fed. Cir. 1988).

71. Rev. Rul. 87-117, 1987-2 C.B. 61.

72. Priv. Ltr. Rul. 88-50-016 (Sept. 15, 1988).

established *regulatory asset*. The electric utility had applied for but could not obtain approval of a license for plant operation. In recognition of the utility's worsening financial condition, a state public service commission (PSC), charged with regulating the utility's rates, increased the rates under a financial stability adjustment and thereby improved the utility's cash flow.

The utility then entered into certain agreements with a new, state-created entity which were intended to bring about the abandonment and decommissioning of the plant. Under the agreements, the utility would receive rate increases effected through the creation and amortization (for regulatory purposes) of a *regulatory asset* with earnings allowed on the unamortized portion of such asset. The recovery of the regulatory asset was the PSC's mechanism for institutionalizing the rate relief that the PSC had previously granted in the form of the financial stability adjustments.

The Service ruled that when the agreements between the utility and the new entity take effect, the utility will sustain a deductible abandonment loss that is not compensated either by insurance or within the meaning of section 165(a). The Service ruled that the utility's receipt of the rate increase as an inducement to plant abandonment did not constitute compensation which would preclude section 165 treatment. In so ruling, the Service cited and expressly followed Revenue Ruling 87-117, wherein it stated that even if a state regulatory commission gives consideration to a utility's abandonment and loss in determining that a rate increase is warranted, the increase need not be structured to reimburse the utility for the loss.

To the extent that the facts of Private Letter Ruling 88-50-016 are unusual or unique, they do not adequately illustrate the full range of the possible applications of Revenue Ruling 87-117.

4. Nuclear Plant Decommissioning Reserve Funds

a. Final Regulations on Decommissioning

On February 29, 1988, the Service issued its final regulations on qualified nuclear decommissioning reserve funds under Code section 468A.⁷³ The regulations became effective July 18, 1984, and apply to taxable years ending on or after that date. In the preamble to the final regulations, the Service discussed a number of public comments on the proposed regulations and its disposition of these issues. The Service rejected the suggestion that moneys collected by municipalities should not be included in the taxpayer's cost of service. The Service concluded that the costs included in the cost of service "includes all decommissioning costs that consumers are liable to pay by reason of electric energy furnished by the taxpayer during such taxable year." This rule applies even if the costs are not payable to (or on behalf of) the taxpayer until decommissioning occurs.

Although the Service rejected the suggestion that members of a consolidated group be treated as one taxpayer for purposes of section 468A, it indi-

73. T.D. 8184, 1988-17 I.R.B. 4 (1988).

cated that administrative burdens on consolidated groups have been eased. For example, the Service stated, nuclear decommissioning fund qualification requirements have been modified to permit a single trust for two or more nuclear decommissioning funds.

Finally, the Service noted that the treatment of dispositions of an interest in a nuclear power plant has been postponed and will be dealt with in later regulations. The Service cited substantial criticism of a provision in the temporary regulations that would have treated such dispositions as deemed distributions by the nuclear decommissioning fund relating to the transferred interest.

b. Cases and Rulings on Decommissioning Funds

In I.R.S. Notice 88-105,⁷⁴ the Service attempted to clarify ambiguities surrounding the method of accounting used by nuclear decommissioning funds. The Service announced that nuclear decommissioning funds under Code section 468A and designated settlement funds under section 468B must use the same accounting method as used by the electing taxpayer. Taxpayers are to disregard the instructions to the contrary in Forms 1120-DF and 1120-ND.

The Service issued numerous private letter rulings in 1988 approving schedules of deductible nuclear decommissioning amounts submitted by electric utilities under Code section 468A.⁷⁵ However, the Service proposed to disapprove a rural electric cooperative's schedule of deductible decommissioning amounts, because the schedule had not received the approval of any public utility commission that establishes or approves the rates charged by the cooperative for electric energy generated by the nuclear plant.⁷⁶

Rural electric cooperatives have special problems with nuclear decommissioning reserve funds. Generally, a cooperative's income will be exempt from federal income tax as long as eighty-five percent of its annual income excluding qualified pole rentals and the prepayment of Rural Electrification Assn. (REA) loans, consists of amounts collected from members for the sale of electricity.⁷⁷ Interest, dividends, and other similar income may not exceed fifteen percent of the cooperative's income.⁷⁸

In the early years of a decommissioning fund, when the corpus is small, the investment income will be relatively low. As long as the fund's income

74. I.R.S. Notice 88-105, 1988-38 I.R.B. 21.

75. Priv. Ltr. Rul. *E.g.*, 88-01-024, 88-04-037 & 38, 88-05-013, 88-07-060, 88-08-035, 88-08-048, 88-09-077, 88-10-017, 88-11-047, 88-12-028 & 29, 88-12-058, 88-12-070 through 75, 88-18-030 & 31, 88-19-013, 88-19-015, 88-20-029, 88-20-033, 88-20-048, 88-20-064, 88-21-028 & 29, 88-21-056 & 57, 88-22-010 & 11, 88-23-007 through 10, 88-23-012 & 13, 88-25-022, 88-29-052, 88-32-007, 88-34-037, 88-35-055, 88-36-054.

76. See Statement of Thomas M. Strait, Ernst & Whinney Utility Group, before the Committee on Joint Ownership Meeting, "Nuclear Decommissioning Tax Deductions and Rural Electric Cooperatives" (March 16-17, 1988).

77. I.R.C. § 501(c)(12) (1986); Prop. Treas. Reg. § 1.501(c)(12)-2, 49 Fed. Reg. 1245 (1984).

78. Prop. Treas. Reg. § 1.501(c)(12)-2, 49 Fed. Reg. 1245 (1984).

will not cause a cooperative to fail the eighty-five percent test, it will be to the cooperative's advantage to count the fund's income as its own, thereby extending its tax-exempt status to the income earned by its nuclear decommissioning fund. Until the Nuclear Regulatory Commission (NRC) issued its new decommissioning regulations, one way to do this was to set up an internal reserve fund. The NRC's new regulations⁷⁹ provides that an internal sinking fund will no longer meet the NRC's financial assurance requirements.⁸⁰ Financial assurance now must be provided by one of three methods: (1) *prepayment* into a segregated account outside the licensee's administrative control; (2) an *external sinking fund* in a segregated account outside the licensee's administrative control; or (3) *surety*, insurance or other guarantee method. A segregated account used for prepayment or an external sinking fund may be in the form of a trust, escrow account, government fund, certificate of deposit or deposit of government securities.

Cooperatives have been concerned that if they set up a segregated account meeting the NRC's requirements, the Service might deem the fund to be a separate taxable entity not covered by the cooperative's tax-exempt status. Fortunately, the Service has not taken such a position. In Private Letter Ruling 88-03-082,⁸¹ the Service allowed a cooperative to include decommissioning fund income within the cooperative's income, even though the decommissioning fund was established under a grantor trust as a segregated account outside the cooperative's administrative control. The Service reasoned that the cooperative should be treated as the owner of the trust under Code section 677, because the trust would pay decommissioning costs which the cooperative was legally obligated to pay.

IV. FORECAST FOR 1989

The oil industry may obtain some tax relief in 1989 if President Bush is able to marshal his forces on Capital Hill. During the campaign, Bush promised that as President, he would seek amendments to the Code to provide several tax incentives for oil drilling and production.⁸² These would include tax incentives to save marginal wells, to encourage exploration for new oil and to improve the recovery of oil still in place.⁸³ In addition, Bush indicated that he would support the restoration of tax incentives for business in general, including a reduction of the capital gains rate to fifteen percent. In his attempt to implement these proposals, President Bush will have to contend with pressures to reduce the federal deficit. Although Bush has promised not to raise federal taxes, some have suggested that the pressure to raise revenue may be overwhelming.

79. 10 C.F.R. § 5.75(e)(1).

80. 53 Fed. Reg. at 24033, 24050 (1988) (to be codified at 10 C.F.R. pts. 30, 40, 50, 51, 70, 72).

81. Priv. Ltr. Rul. 88-03-082 (Oct. 29, 1987).

82. See Campaign Statement, "Vice President George Bush on the Issues," p. 9.

83. See Republican Party Platform p. 62 (Aug. 15, 1988).

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