APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE SETTLEMENT GUIDELINE

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ISSUE:	Excess Deferred Taxes and Section 1341
COORDINATOR:	Pat Hallick
TELEPHONE:	(216) 623-2035
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Jeffrey Allison 12/5/96

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SETTLEMENT GUIDELINE

EXCESS DEFERRED TAXES AND SECTION 1341

ISSUE

Whether a regulated public utility (the taxpayer) may compute its Federal income tax liability under I.R.C. § 1341(a) for passing through rate reductions to its customers, ordered by the appropriate regulatory authority, attributable to the elimination of "excess deferred taxes" as a result of the Reform Act of 1986.

BACKGROUND

This issue was approved by the Office of Chief Counsel for Exam coordination on April 24, 1995.

FACTS

The taxpayer owns public utilities, which include electric, telephone, gas pipeline, local gas distribution and water companies that are regulated by state and Federal regulatory commissions. To obtain reasonable rates for customers as well as a stable supply of services, regulators allow these utilities to earn both a fair rate of return on their investment and to recover their operating expenses (i.e., cost of service). Utilities are allowed (1) to charge ratepayers an approved rate of return on their rate base, which is composed of the plant facilities, working capital, and other assets required to provide utility services to customers, and (2) to secure reimbursement on a dollar-for-dollar basis for all operating expenses.

Federal income taxes are a major component of a utility’s operating expenses (cost of services) for ratemaking purposes. The Federal income tax cost that a taxpayer uses in determining rates is different from its actual Federal income taxes. This is primarily due to differences between net income determined for financial (ratemaking) accounting purposes and taxable income determined for Federal income tax purposes. These differences are largely caused by timing of expenses such as depreciation. For example, utilities ordinarily use straight-line depreciation for book (ratemaking) purposes. In contrast, accelerated depreciation is used in computing taxable income. Accordingly, such differences may result in higher Federal tax expense being used by a taxpayer for purposes of determining rates to customers than the actual Federal tax expense. In years 1975 through 1986, the collections for Federal income taxes (both current and deferred) were calculated using tax rates of 46% and above. The Tax Reform Act of 1986 reduced the corporate Federal statutory income tax rate from 46% to 34% effective July 1, 1987, with a "blended" rate of 39.95 percent for 1987. As a result of this reduction in tax rates, the deferred income taxes collected by taxpayer in prior taxable years at a 46% rate (or higher) exceeded what would be the taxpayer's actual income tax expense (34%) for later years. This excess is referred to as "excess deferred taxes". The excess deferred taxes represent an amount collected by a taxpayer to cover future expenses that, as a result of a subsequent reduction of Federal income tax rates, no longer need to be paid.

The regulatory authorities' reaction to excess deferred taxes has varied. The Federal Energy Regulatory Commission ("FERC") in FERC order 144, 46 FR 26613, indicated that

The Commission agrees that tax laws and, particularly, tax rates may change, but we also agree with the reply comments that this possibility is not a basis for failing to provide for deferred taxes. If income taxes are computed on a normalized basis for cost of service purposes, items of expense and revenue entering into the cost of service determination are also used in determining the income tax allowance portion of the cost of service. The tax effects, determined at the current tax rate, of the difference between the amounts so used and the amounts claimed in the tax return are placed in a deferred tax account to be used in later periods when the differences reverse. The balance in the deferred tax reserve is therefore a residual of past tax costs over past tax payments and may or may not be sufficient to cover future tax payments over future tax costs, depending on the statutory tax rates in the future. Any excess or deficiency in the deferred tax reserve does not, however, result in a windfall to either shareholders or ratepayers since the balances will systematically be subject to a reconciliation in future rates.

As stated in the reply comments, any disparity between the actual tax effect in the year the timing difference originates and in the year the timing difference reverses is a normal and inherent part of the accounting process. This variation is no more than that involved in assigning the original cost of properties used in providing customer service to the periods of use. Simply because the deferred tax accounting process may not assign the "perfect" amount to each respective period is no reason to reject the practice.

FERC did not mandate retroactive ratemaking or mandate rate refunds. Instead, FERC established a rule whereby utilities were to establish a plan to systematically reconcile such excess (or deficiency) in establishing future rates.

Generally, state regulatory bodies appear to have taken a similar approach as that embraced by FERC. Excess deferred taxes have not caused retroactive rate adjustments but rather have been subjected to reconciliation in future ratemaking proceedings. Nevertheless, in order to ensure reconciliation, many state authorities have ordered utilities to pass through the savings attributable to the excess deferred taxes to the taxpayer's retail or wholesale customers. The passthroughs approved or ordered by the state commissions have been in the form of a credit on a customer's bill or a permanent rate reduction to bring a taxpayer's rates in line with its actual costs.

As public utilities have "returned" these excess deferred taxes to ratepayers, pursuant to regulatory orders, they have computed their Federal income tax liability using the tax mitigation provision provided under I.R.C. § 1341.

EXAMINATION DIVISION'S POSITION

The Examination Division has determined that I.R.C. § 1341 treatment does not apply for two reasons:

1. Regulatory orders associated with tax rate changes and tax normalization establish regulatory policy that the rates should be systematically reconciled; such expected future reductions in rates do not qualify as a cost or a deduction for Federal income tax purposes but more properly are an adjustment to gross receipts rather than a deductible liability. Similarly, the reversals of "excess deferred taxes" are not rate refunds or retroactive rate adjustments but merely are a reversal of deferred taxes to guarantee that deferred tax balances are "zeroed out". The statutory language of I.R.C. § 1341(a)(2) and Treas. Reg. 1.1341-1(a)(1) make it clear that I.R.C. § 1341 does not apply unless there is an allowable deduction.

2. The deferred taxes at issue were collected based on the then existing Federal statutory tax rate; the utility had an absolute right to the income (represented by the deferred taxes) in fact and in law. The fact that the deferred taxes have now become "excessive" due to a change in the Federal statutory tax rate is a subsequent event. I.R.C. § 1341 does not apply if a taxpayer has a right to income based on facts that existed at the close of the taxable year of inclusion, but loses the right to that income in a subsequent taxable year based on a subsequent event.

TAXPAYER'S POSITION

The Taxpayer contends that it is entitled to apply I.R.C. § 1341 with respect to the amount of excess deferred income tax reserves that were refunded to ratepayers for the following reasons:

1. The Taxpayer contends that the event that establishes that

the Taxpayer has no right to the excess deferred taxes is the orders by the regulators that the Taxpayer pass through the excess deferred taxes to its customers and not the reduction of Federal income tax rates. Proof that the change in tax rates did not cause excess deferred taxes to be refunded to ratepayers is based on the fact that the state regulatory commissions did not order all regulated utilities within a state to refund all excess deferred taxes to ratepayers.

2. The Taxpayer contends that the public utility exception of Treas. Reg. 1.1341-1(f)(2)(i) preempts the government from denying I.R.C. § 1341 relief since Congress anticipated that at least some refunds made by public utilities would be eligible for treatment under I.R.C. § 1341. Treas. Reg. 1.1341-1(f)(2)(i) indicates that I.R.C. § 1341 applies "to deductions which arise out of refunds or repayments with respect to rates made by a regulated public utility, if such refunds or repayments are required to be made by the government, political subdivision, agency or instrumentality referred to in such section, or are required to be made by an order of a court, made in settlement of litigation or under threat or imminence of litigation."

3. The Taxpayer contends that by virtue of the order to refund by the regulators that in effect the refunds represent a retroactive rate change which closely parallels Situation 3 in Rev. Rul. 68-153, 1968-1 C.B. 371, in which I.R.C. § 1341 relief was granted.

4. The Taxpayer argues that neither the Code nor the Regulations provide that a restoration caused by a subsequent event is fatal to the application of I.R.C. § 1341. The Taxpayer relies on Van Cleave v. United States, 718 F. 2d 193 (6th Cir. 1983) and Prince v. United States, 610 F. 2d 350 (5th Cir. 1980).

5. The Taxpayer contends that its situation is a classic example of why Congress enacted I.R.C. § 1341 and that the Service's position has historically been to allow

I.R.C. § 1341 relief so long as the refund is not voluntary and is ordered by or mandated by a regulatory body. The taxpayer cites Rev. Rul. 72-28, 1972-1 C.B. 269, and numerous private letter rulings to support its position.

LEGAL DISCUSSION

I.R.C. § 1341 provides rules for computing tax liability where a taxpayer restores a substantial amount of income held under a "claim of right". If a taxpayer satisfies the requirements of I.R.C. § 1341, its tax liability will be the lesser of two computations.

To be eligible under the general rule if I.R.C. § 1341(a), a taxpayer must satisfy the following three requirements:

1. An item was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to such item;

2. A deduction is allowable for the taxable year because it was established after the close of such prior taxpayer year or years that the taxpayer did not have an unrestricted right to such item, or a portion of such item; and

3. The amount of the deduction exceeds $3,000.

If these requirements are satisfied, the tax imposed for the taxable year shall be the lesser of: (1) the tax for the taxable year computed with such deduction, or (2) an amount equal to the tax for the taxable year computed without such deduction, minus the decrease in tax under Chapter 1 for the prior taxable year or years resulting solely from the exclusion of such item, or a portion of the item, from
gross income for such prior taxable year of years.

I.R.C. § 1341(b)(2) provides that I.R.C. § 1341(a) does not apply to deductions allowable with respect to income from the sale of inventory or property held for sale to customers. However, this exception does not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility and such refunds or repayments are required by a governmental entity described in I.R.C. § 7701(a)(33), (including a public service commission) or by an order of a court or made in settlement of litigation or under threat or imminence of litigation.

For purposes of the issue presented herein, the two most important criteria are the establishment by the Taxpayer of an apparent unrestricted right and that a deduction is allowable in the current year.

DEDUCTION IN CURRENT YEAR

In order to establish that a deduction is allowable in the current year, the Taxpayer must look outside I.R.C. § 1341 primarily to I.R.C. §§ 162 and 165 to establish that a deduction is "allowable". Blanton v. Commissioner, 46 T.C. 527 (1966) and United States v. Skelly Oil Co., 349 U.S. 678 (1969). I.R.C. § 1341 is concerned exclusively with the COMPUTATION of a tax liability.

In Iowa Southern Utilities Co. v. United States, 841 F. 2d 1108 (Fed. Cir. 1988), aff'g, 11 Cl. Ct. 868 (1987), a public utility received permission from the state regulatory agency to impose a surcharge on customers' bills to finance the interest on construction financing of a new power plant. The company was required to refund the surcharge through a negative surcharge over a 30-year period after the plant was placed in service, but was not required to include interest in the negative surcharge. The utility argued that if the surcharge was considered income, then the company was entitled to an offsetting deduction because of its obligation to credit negative surcharges to its customers' bills over a 30-year period.

The court concluded that the utility's tariff providing for the negative surcharge did not establish a liability to make the refund, but rather set out regulatory policy on allowable rates for electric service. The Federal Circuit focused on the fact that the negative surcharge is applied to the bills of all customers during the 30-year period it is in effect, without regard to whether they were customers when the surcharges were assessed. Former customers who paid surcharges had no entitlement to any money and current customers who paid surcharges could not purchase electricity at a rate more favorable than current customers who did not pay the surcharges.

The court further concluded that it was incorrect to view the future rate reduction as a deductible expense, that is, a cost incurred in the process of producing the income generated through the allowed increase in charges. The court viewed the utility as enjoying higher rates and greater income during the period the surcharge was in effect and lower rates and less income during the period the negative surcharge was in effect.

In Iowa Southern, 11 Cl. Ct. at 874, the Claims Court stated:

A deduction, for federal income tax purposes, involves a cost or expenditure that is incurred in the process of producing income from a trade or business. See I.R.C. § 162(a). We do not have that here. Granted, the language of the stipulation, and also that of the tariff sheets, speaks in terms of a "refund" of the surcharges. But the fact of the matter is that these documents set up no obligation to pay; they establish no liability. Rather, all that they accomplish is a declaration of regulatory policy: that rates shall be raised in certain years and then lowered in subsequent years to offset the increase. It suggests a confusion in thought to argue that the expected future reduction in the charges for electric service qualify as a cost, i.e., a deduction, incurred in the process of producing the income generated through the allowed increase in charges. Perhaps in some broad economic sense there may be room for that sort of argument, but not in federal tax law. The negative surcharges represent a price change, not a liability. Accordingly, there existed no deductible expense to accrue.

In Roanoke Gas Co. v. United States, 977 F 2d 131 (4th Cir. 1992), aff'g Civil No. 89-0692 (W.D. Va. 1991), the court held that the negative fuel adjustment involved in that case reduced future gas service rates. Roanoke Gas is a public utility whose rates are regulated by the Virginia State Corporation Commission (VSCC). Roanoke's rates were prospective in that they were designed to recover Roanoke's cost of purchasing the gas that Roanoke sold during the period that the rate was in effect. The base rate was derived from the previous year's gas cost. At the end of each year, Roanoke compared the actual cost of gas purchased that year with its recoveries of the cost of that gas. To the extent that Roanoke over recovered its costs, it had to reduce its rates for the following year (without interest). (Conversely, Roanoke is allowed to increase its rate for the following year to recoup under recovered amounts.) The amount that any particular customer was overcharged was not computed. Rather, the negative adjustment was made in the overall rate charged all customers in the year following the over recovery. For financial accounting purposes, VSCC required Roanoke to account for the obligation to adjust future rates to account for over recoveries as a liability.

The Fourth Circuit concluded that the obligation to reduce future rates bore few, if any, characteristics of a liability for past overcharges. The court focused on the fact that the rate reduction applied to a customer whether or not the customer actually was overcharged. When a customer overpaid for gas and left the service area, that customer did not have a claim for overpayment.

Likewise, when a new customer entered the service area, that customer received the benefit of the reduced rate without having overpaid for gas in the prior period. The court noted that the utility did not segregate the over recovered funds, impose limitations on their use, or pay interest on the funds ultimately returned. The court viewed the rate reduction caused by the negative fuel adjustment as normal ratemaking. It stressed that the fuel adjustment merely operates to control the amount of income Roanoke may receive relative to its purchased gas cost as measured by the previous year's experience. The court also found that the utility's tariff sheets simply evidence a declaration of regulatory policy that gas service rates are to reflect, as accurately as possible, the actual cost of purchased gas. Finally, the court held that the treatment of the rate adjustment as a liability for financial accounting purposes did not control its characterization for tax purposes.

Similarly, the Tax Court also has held that a utility's obligation to reduce future rates to pass through an over recovery of fuel costs arising from operation of a fuel adjustment clause is a future gas service rate adjustment, and does not give rise to a liability that is deductible under I.R.C. § 162. Southwestern Energy Company v. Commissioner, 100 T.C. 500 (1993). The Tax Court adopted much of the rationale in Roanoke Gas.

Iowa Southern, Roanoke, and Southwestern Energy illustrate ratemaking situations when expected future rate reductions were held not to represent current deductions from taxable income, but merely regulation of income through rates. The tax normalization rules in FERC Order No. 144 (and restated in FERC Order No. 475) concerning tax rate changes are also recognized future rate reductions and, similar to Iowa Southern, Roanoke, and Southwestern Energy, do not represent current deductions from income but rather future reductions in income. Based on the above, the Taxpayer's passing through to its customers the savings attributable to the reduction in its Federal income tax rates appears strongly to be an adjustment to gross receipts rather than a deductible liability. The provisions of I.R.C. § 1341, therefore, are inapplicable.

Even if the orders causing Taxpayer to pass through the benefits of the tax savings attributable to the reduction in Federal income tax rates were considered to give rise to a deductible liability, the Taxpayer would still not be entitled to the benefits of I.R.C. § 1341. The Taxpayer would still fail to satisfy the requirements of I.R.C. § 1341(a)(1).

APPARENT UNRESTRICTED RIGHT

Treas. Reg. 1.1341-1(a)(2) provides that "income included under a claim of right" is an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such income, and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

In Rev. Rul. 58-226, 1958-1 C.B. 318, the taxpayer sold real property, taking back a ten-year note as part of the sales price. The purchaser prepaid the interest on the note, but under the agreement the taxpayer was obligated to give the purchaser credit, upon prepayment of any part of the principal, for the portion of the prepaid interest applicable to the period from the date of prepayment of the principal to the date to which the interest was prepaid. The Service determined that a later credit of the prepaid interest by the taxpayer did not qualify for the benefits of I.R.C. § 1341 because the taxpayer had an unrestricted right to receive the total amount of the prepaid interest. The revenue ruling further holds that if in a subsequent year the taxpayer credits the payer with prepaid interest, it is doing so because a liability on the taxpayer's part has later accrued which does not in any way establish that he had no right to the interest when received.

Rev. Rul. 67-48, 1967-1 C.B. 50, holds that I.R.C. § 1341 does not apply to liquidated damages paid to a former employer for the employee's breach of an employment contract because the employee had an unrestricted right to receive the amount of compensation initially paid. The obligation to repay a portion of the salary in the form of liquidated damages arose as a result of subsequent events--the employee's failure to perform services for the period promised.

Rev. Rul. 68-153, 1968-1 C.B. 371, discussed the applicability of I.R.C. § 1341 to four different situations involving a railroad that restored amounts collected in prior years. In situation 1, the railroad billed the government at high rates during World War II subject to refunds in later years when wartime security restrictions were lifted. In the original year of inclusion, the facts available did not allow the taxpayer to determine that lower rates were applicable.
In situation 2, mere error, such as errors in arithmetic, resulted in overcharges to customers. In the year of inclusion, all the facts available would have allowed the taxpayer to correct the errors.

Situation 3 involved a retroactive rate change by a regulatory agency that required the taxpayer to make refunds to customers. In the year of inclusion, all the facts available indicated that the rate was correct.

In situation 4, all of the facts available in the year of inclusion indicated that the amount received was correctly computed. However, all or part of the amount was restored to the customer because of a subsequent event, such as the return of an unused passenger ticket, or a transit adjustment arising when goods shipped and billed at a local freight rate become entitled to a lower rate.

Rev. Rul. 68-153 holds that I.R.C. § 1341 applies in situations 1 and 3, but not in situations 2 and 4. In situations 1 and 3, I.R.C. § 1341 applied because the railroad appeared to have an unrestricted right to the income in the year of inclusion, and it could not be determined, in fact or in law, until a subsequent year that the railroad did not have an unrestricted right to the income.

In situation 2 the railroad had no right to the included amount based on all the facts available at the end of the year of inclusion. Moreover, the taxpayer did not have an appearance of a right to the income because these facts could have been but were not readily ascertained by the taxpayer. In situation 4 the railroad had a right in the year of receipt to retain the amount included in income. A subsequent event, such as a passenger not using the return trip portion of a round-trip ticket, in a later year caused the railroad to return the previously included income.

For Section 1341 of the Code to apply to a repayment of an item of income, a taxpayer must have a semblance of entitlement to the item in the taxable year in which it is included in the taxpayer's gross income. There must be a factual or legal uncertainty concerning the taxpayer's right to the item of income in that year. Thus, I.R.C. § 1341 does not apply if a taxpayer has a right to income in the taxable year it is included in the taxpayer's gross income, but the taxpayer voluntarily pays the income back in a subsequent taxable year. See, e.g., Kappel v. United States, 437 F.2d 1222 (3d Cir. 1970), cert. denied, 404 U.S. 830 (1971) (I.R.C. § 1341 does not apply to repayments of pension fund distributions if there is no legal obligation to return the distributions to the pension funds).

On the other hand, if it is clear that a taxpayer has no bona fide claim of right to income when the taxpayer included it is gross income; the taxpayer does not have a claim of right to the income within the meaning of Treas. Reg. 1.1341-1(a)(2). See Yerkie v. Commissioner, 67

T.C. 388 (1976): McKinney v. United States, 574 F. 2d 1240 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979) (embezzled funds not held under a claim of right, therefore repayments of such funds not subject to I.R.C. § 1341).

Furthermore, if a taxpayer includes an amount in income because of a "mere error", for example by overcharging customers because of mathematical errors made by the taxpayer in billing, I.R.C. § 1341 does not apply. See Rev. Rul. 68-153, situation 2. I.R.C. § 1341 does not apply in the case of a mere error because at the end of the taxable year the taxpayer has access to all the information the taxpayer needs to determine that the taxpayer is not entitled to the income. The "uncertainty" as to the taxpayer's right to the income is attributable to the taxpayer's own errors rather than to extrinsic circumstances beyond the taxpayer’s control.

Rev. Rul. 68-153 provides that the term "appeared" as used in I.R.C. § 1341 and in § 1.1341-1(a)(2) of the Regulations refers to a SEMBLANCE of an UNRESTRICTED RIGHT in the year received as distinguished from an UNCHALLENGEABLE RIGHT (which is more than an "apparent" right) and from ABSOLUTELY NO RIGHT AT ALL (which is less than an "apparent" right). Whether the taxpayer has the semblance of an unrestricted right in the year of inclusion depends upon all the facts available at the end of such year. Under § 1341 it must be established in a subsequent year that in the year of inclusion that taxpayer did not in fact or in law have an unrestricted right to the amount in question.

Herein, the amount of Federal income taxes that the Taxpayer collected from its customers was calculated based on a 46% Federal income tax rate. This was the correct rate for the Taxpayer to use to determine its deferred Federal income tax expense at the time these amounts were collected from the Taxpayer's customers. No uncertainty existed at that time as to the Taxpayer's right to this item. Thus, as of the close of the taxable year in which the amount collected for deferred income taxes was included in Taxpayer's gross income, the Taxpayer had an actual (as opposed to an apparent) unrestricted right to that amount.

It was only after a reduction in the Federal income tax rates that the Taxpayer lost its right to its excess deferred taxes (the portion of the deferred taxes that exceeded what would be needed to cover its future Federal income tax expense) and was required to pass through this amount to its customers. This reduction in Federal tax rates occurred after the end of the taxable years in which the excess deferred taxes were included in the gross income of the Taxpayer. Thus, any loss of the Taxpayer's right to this amount in a later taxable year appears to be due to a subsequent event that did not in any way defeat the Taxpayer's right to the amount in the taxable year of inclusion. Therefore, I.R.C. § 1341 does not apply in determining the Taxpayer's Federal income tax liability in the year the excess deferred taxes are passed through to its customers.

The present issue is similar to situation 4 in Rev. Rul. 68-153. In that situation, the freight or passenger rate charged by the railroad to its customers was properly computed in the taxable year of inclusion. It was only as a result of an event occurring after the year of inclusion that the rate charged became excessive and had to be refunded to the customer. The examples given in Situation 4 of a subsequent event are a passenger ticket refund or a transit adjustment arising when goods shipped and billed at a local freight rate became entitled to a lower rate. A passenger ticket refund may occur if a ticket is not used or if a round-trip ticket is used only one way. The trip for which the ticket was purchased may not be scheduled until after the close of the taxable year in which payment for the ticket was made. However, at the time the passenger pays for the ticket, the railroad has a right to the amount received. In such a case, the refund would be the result of a subsequent event. That event is passenger's failure to use the ticket. Rev. Rul. 68-153 provides that I.R.C. § 1341 does not apply to this situation because the refund is the result of a subsequent event.

Similarly, the Taxpayer herein had a right to the deferred income taxes in the taxable year this amount was collected from the Taxpayer's customers. The reduction in Federal income tax rates was the event that precipitated the Taxpayer’s pass through of the excess deferred taxes to its customers. This event occurred after the close of the taxable year in which the amounts were included in the Taxpayer's gross income. Thus, the pass through to customers of the excess deferred taxes was the result of a subsequent event similar to that in situation 4 of Rev. Rul. 68-153 and therefore, I.R.C. § 1341 does not apply to this case.

THE EVENT: FEDERAL RATE CHANGE VS. REGULATORY ORDER

The Taxpayer contends that the event in this case that establishes that the Taxpayer has no right to the excess deferred taxes is the order by the regulatory authority that the Taxpayer pass through the excess deferred taxes to its customers and not the reduction of Federal income tax rates. As support for this contention, the Taxpayer claims that not all utilities under the jurisdiction of the state regulator were required to pass through the savings resulting from the reduction in tax rates.

This argument lacks merit. The regulatory order was the result of the reduction of the Federal income tax rates. The reduction of these rates was the event that caused the amount collected as deferred taxes to become "excess" deferred taxes. The regulatory order was merely the determination that the Taxpayer, as a result of the reduction in the Federal tax rates, no longer had a right to the amount of deferred taxes that had become "excessive". Most taxpayer's cannot supply information or any analysis as to why other utilities were not required to pass through the savings.

Nevertheless, one possibility as to why certain utilities were not required to pass through the savings is that the excess deferred tax amount was offset by a deficiency in another component of the utility's cost of service. In deciding if an adjustment by the utility is required, the regulator may take into account counterbalancing offsets. If the offset equals or exceeds the amount of excess deferred taxes, an order by the regulator would be unnecessary. Therefore, little weight should be attached to the fact that some utilities under the jurisdiction of the regulator (even within the same state) were not ordered to pass through the savings attributable to the excess deferred taxes.

The Taxpayer further believes that its situation resembles situation 3 in Rev. Rul. 68-153 because the regulatory commission ordered the rate changes. However, in situation 3, the regulatory agency made a retroactive change in rates. The retroactive nature of the change provides support for the fact that there was legal uncertainty as to the rate when the railroad collected the charges in the year of inclusion. It was only after a determination was made by the regulatory agency that the proper rate was known. Thus, the railroad in situation 3 of Rev. Rul. 68-153 had only an apparent right to the rates collected. The condition that defeated this apparent right was in existence in the taxable year in which the item was included in gross income. It was only the determination that this condition existed that was made in a subsequent taxable year. Thus, the ruling held that I.R.C. § 1341 applied in this situation. As the ruling notes, without the existence of such uncertainty, the taxpayer would have had an unchallengeable right to the income and could not have applied I.R.C. § 1341.

The instant situation can be distinguished from situation 3. With respect to "excess" deferred taxes, the regulatory authority did not "retroactively" change the rates from which the income was generated. The amount collected by the Taxpayer for deferred income taxes was not determined by the regulators to be improper in the taxable years such amounts were collected. Rather the occurrence of an event after such taxable years, the reduction of Federal income tax rates, caused a portion of the amount collected for the deferred taxes to become excess. This excess was then required by the state regulator to be passed through to customers. Unlike situation 3, the pass through of the excess deferred taxes was caused by a subsequent event (the change in the Federal statutory tax rate). The pass through was not caused by any circumstances, terms or conditions arising in the year of inclusion.

In Blanton v. Commissioner, 46 T.C. at 530, the Tax Court stated that, "[u] under section 1341(a)(2), the requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, terms, and conditions of the ORIGINAL payment of such item to the taxpayer and not out of circumstances, terms, and conditions imposed upon such payment by reason of some subsequent agreement between payor and payee".

Herein, the Taxpayer's pass through of amounts to its customers arose from the creation of excess deferred taxes caused by a change in the Federal statutory tax rate. However, the Taxpayer had an actual unrestricted right to the income as of the close of the taxable year in which it was received. The reduction in Federal tax rates in a later taxable year, and the resulting action ordered by the regulatory commission, did not alter or defeat the Taxpayer's unrestricted right in the taxable year of receipt. Thus, in this case there is no restriction on the Taxpayer's right to the income term arising out of the circumstances, terms and conditions of the original receipt of such item by the Taxpayer. Therefore, the taxpayer's entitlement to I.R.C. § 1341 is not strong.

SUBSEQUENT EVENT

The Taxpayer argues that neither the Code nor the Regulations provide that a restoration caused by a subsequent event is fatal to the application of I.R.C. § 1341. The Taxpayer relies on <u>Van Cleave v. United States</u>, 718 F.2d 193 (6th Cir. 1983), for this argument.

In <u>Van Cleave</u>, the taxpayer was required to repay a portion of his salary that the Internal Revenue Service found to be excessive and thus, not deductible by the corporation. The repayment of the excessive salary was required by the corporation's by-laws that were in effect at the time the taxpayer received the excessive amount. The taxpayer was found to be entitled to relief under I.R.C. § 1341. In holding for the taxpayer, the Sixth Circuit held that

The fact that a restriction on a taxpayer's right to income does not arise until a year subsequent to the time of receipt does not affect the availability of section 1341 tax adjustment. [718 F. 2d 197.]

However, the court was not denying the existence of the "subsequent event" test. Although the determination that the salary was excessive was not made until a later year, the excessiveness of the salary was a fact in existence (although unknown) in the year it was received. The taxpayer's lack of a right to the excessive salary was not the result of a subsequent event. There was, however, a determination in a subsequent year that this lack of a right existed. Therefore, I.R.C. § 1341 was held applicable to the taxpayer's situation in <u>Van Cleave</u>. The court was merely pointing out that a <u>determination</u> which a taxpayer did not have a right to an item of gross income, that is made subsequent to the taxable year that the taxpayer includes the item in gross income, does not defeat the application of I.R.C. § 1341. Indeed, under I.R.C. § 1341(a)(2) it must be established, after the close of the taxable year of inclusion, that in the taxable year of inclusion that taxpayer did not have an unrestricted right to the item of income. Accordingly, Van Cleave does not support the Taxpayer's argument.

The Taxpayer also relies on Prince v. United States, 610 F.2d 350 (5th Cir. 1980). In Prince, a state court ruled that a decedent, a trust beneficiary, had received trust funds that should have gone to the trustee. The decedent's estate was required to return the funds to the trustee. The court held that the taxpayer, "appeared to have an unrestricted right to the income when she received it; it was established in a taxable year after she received it that she did not have such a right." Id. 610 F.2d at 352. Thus, the requirements of I.R.C. § 1341 were satisfied.

Prince also does not support the Taxpayer's argument because, as in Van Cleave, the beneficiary's lack of a right to the trust funds was a fact in existence at the time the funds were received. It was only the determination that no right existed that was made in a subsequent year.

The Service does agree with the Taxpayer that I.R.C. § 1341 could apply to discoveries of a lack of a right to an income item in a subsequent year where such lack of a right existed in the year the item was included in gross income. The Taxpayer's case is different, however, because the lack of a right did not exist at the time the item was included in the Taxpayer’s gross income.

While the Taxpayer has demonstrated that it had to pass through savings attributable to the reduction in Federal income tax rates to its customers, there is no showing that this was attributable to a defect in the ownership right of the Taxpayer to the item of income in the original year of inclusion. As a consequence, the Taxpayer has failed to satisfy the requirements of I.R.C. § 1341.

PUBLIC UTILITY EXCEPTION

Treas. Reg. 1.1341-1(f)(2)(i) provides that the provisions of I.R.C. § 1341 apply to deductions that arise out of refunds or repayments with respect to rates made by a regulated public utility, as defined in I.R.C. § 7701(a)(33), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or are required to be made by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are eligible for the benefits of I.R.C. § 1341 if such refunds are required by the governmental authority, or by an order of a court, or made in settlement of litigation or under threat or imminence of litigation.

The Taxpayer contends that Treas. Reg. 1.1341-1(f)(2)(i), cited above, preempts the Service from denying I.R.C. § 1341 relief to the Taxpayer. They argue the Regulations clearly provide such relief to a public utility when ordered by a regulatory body to refund money to ratepayers.

The public utility exception is an exception to the limitation contained in the first sentence of I.R.C. § 1341(b)(2). That limitation provides that I.R.C. § 1341 generally does not apply to deductions that relate to property that is stock in trade of the taxpayer or that would have been included in inventory if on hand at the close of the taxpayer's taxable year. The public utility exception merely permits a taxpayer's refunds to be considered under I.R.C. § 1341(a). It does not suggest that I.R.C. § 1341 applies to ANY refund ordered by a governmental authority. The refunds must still satisfy the requirements imposed by I.R.C. § 1341(a).

Treas. Reg. 1.1341-1(f)(2)(i) is nothing more than an exception to Treas. Reg. 1.1341-1(f)(1). I.R.C. § 1341(b)(2) begins by denying § 1341 relief to all taxpayers with respect to refunds related to the sale of inventory items to customers. However, I.R.C. § 1341(b)(2) goes on to exclude regulated public utilities from this rule. Treas. Reg. 1.1341-1(f)(2)(i) simply explains this exception. Treas. Reg. 1.1341-1(f)(2)(i) does not exempt regulated utilities from the ordinary rules of I.R.C. § 1341(a).

The Taxpayer contends that the foregoing interpretation has not been followed by the Service. The Taxpayer cites Rev. Rul. 72-28, 1972-1 C.B. 269, as support of its position.

In Rev. Rul. 72-28, a regulated public utility was subjected to a series of purchased gas rate increases allowed by the Federal Power Commission, <u>subject to refund</u> under certain circumstances. The utility collected its increased purchased gas expense from its customers, subject to refund to the customers under a binding legal obligation if the utility received a refund from its suppliers. The increased gas cost was taken into account as part of the utilities cost of good sold deduction. In a later year, the utility received refunds from the gas supplier and in turn made refunds to its customers.

The revenue ruling holds that I.R.C. § 1341 applies to this situation. In so holding, the Ruling examined whether the public utility exception to the stock in trade rule of I.R.C. § 1341(b)(2) applied. The question arose because the refunds to consumers were not made as a result of an order by a government authority or a court order. However, since there was a legally binding obligation for the utility to make the refund, and therefore, the customers could commence litigation to enforce the refund, it was determined that the public utility exception to I.R.C. § 1341(b)(2) applied. It was also held that the fact that the utility included the purchased gas rate increases in cost of good sold had no relevancy in determining the application of I.R.C. § 1341.

The Taxpayer states that Rev. Rul. 72-28 clearly indicates that so long as the refund is not voluntary and is ordered by or mandated by a regulatory body, the benefits of I.R.C. § 1341 are eligible with respect to public utilities. However, the Ruling itself simply states that the provisions of I.R.C. § 1341 are applicable in determining the Federal income tax liability of the taxpayer under the facts of the ruling. There is no statement or suggestion in the revenue ruling that I.R.C. § 1341 applies to any refund by a public utility under a legally binding agreement or an order by a governmental authority. Accordingly, the Taxpayer's interpretation of Rev. Rul. 72-28 is incorrect.

In summary, since the deferred taxes herein were not collected SUBJECT TO REFUND at a later date under a legally binding agreement and since all the requirements of I.R.C. § 1341 are not met, neither the public utility exception nor Rev. Rul. 72-28 support the Taxpayer's position.

PREVIOUS RULINGS

In addition to the above revenue ruling, the Taxpayer also argues that this issue is similar to situations involving refunds by utilities to its customers under energy adjustment rates. The Service has previously issued private letter rulings that hold that I.R.C. § 1341 applies to refunds by utilities under energy adjustment rates. In light of Roanoke Gas and Southwestern Energy, discussed above, those private letter rulings are incorrect with respect to the conclusions drawn therein that rate adjustments resulting from energy adjustment clauses result in deductible

liabilities. Accordingly, the Service has revoked these private rulings.
Moreover, in any event, private letter rulings carry no precedential value. I.R.C. § 6110(j)(3).

<u>SETTLEMENT GUIDELINE</u>

[redacted]

— [redacted].

— [redacted].

— [redacted]

[redacted]

[redacted].

[redacted].