

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 31, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 61.09-01
CASE-MIS No.: TAM-125912-05
Number: **200630018**
Release Date: 7/28/2006
Territory Manager
225 West Broadway
Glendale, CA 91204-1331

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: August 30, 2005

LEGEND:

Company =
State =
Year 1 =
Year 6 =
Year A =
Year B =
BB =
\$C =
\$D =
\$E =
PUC =
The Decision =

The Act =

ISSUE:

Is the gain on the sale of Taxpayer's generation assets includible in gross income under § 61 of the Internal Revenue Code in the year of the sale of the assets?

CONCLUSION:

Proceeds from the sale of Taxpayer's generation assets were received under a claim of right and were, therefore, includible in gross income under § 61 of the Code in the year of sale.

FACTS:

Taxpayer is a public utility holding company organized under the laws of State. One of Taxpayer's wholly owned subsidiaries, Company, is a regulated public utility serving electricity customers in State.

In Year A, PUC began a comprehensive review of the future of regulated electric service in State. The review concluded that, in the future, State's customers should have a choice of electricity suppliers and that traditional cost-of-service utility regulation would be replaced by competition. After three years of deliberations, PUC issued the Decision. The Decision established PUC's plan for restructuring State's electric industry. In Year B, State's legislature passed the Act, establishing the legal framework for the restructuring.

Both PUC and the legislature concluded that competition and choice of providers would be the cornerstone of the deregulated electricity market that was necessary to reduce the cost of electricity to State's citizens. As a result of the restructuring, Company would no longer have an exclusive right to provide bundled services. Company would continue to have an exclusive right to transmit and to distribute electricity within specified service areas in State. Also, while Company retained some generation assets, it would be precluded from providing generation services directly to its customers.

The restructuring program established by the Decision and the Act provided a way for all affected utilities to recover prudently incurred costs for investments in business infrastructure and supply contracts that were "stranded." Stranded costs (also known as "transition costs") included costs incurred for investment in generation assets which were deemed unrecoverable in a deregulated environment. These costs were measured, in part, by the estimated difference in the value of generation assets before and after deregulation. Under the restructuring program, these stranded costs would be recovered by way of an added charge to ratepayers, which was called the "Competition Transition Charge" or "CTC." The CTC recoverable from ratepayers was limited to \$E.

As part of the restructuring program, PUC gave Taxpayer certain positive economic incentives to divest itself of its generation assets. Revenues earned through the sale of the assets were applied directly to transition costs through the Transition Cost Balancing Account ("TCBA"), the same account to which the CTC was credited.

Under traditional ratemaking principles applied by PUC, ratepayers are generally entitled to the benefits of any capital gains accruing from a sale of utility assets and, conversely, are responsible for capital losses as well. Typically, a utility would be required to reduce rates charged to ratepayers to the extent of capital gains received. See, e.g., *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973). In the present case, however, PUC allowed Company to immediately apply the proceeds from the sale of the plants as a credit to the existing balance of the CTC identified by Company and PUC. This allowed Taxpayer to immediately receive and recover part of its transition costs. However, the CTC that could be charged to ratepayers was offset by proceeds from the sale of power generation plants.

Accordingly in Year 1, Company sold all of its gas-fired generation assets, consisting of BB generating facilities for a total book gain of approximately \$C and a total tax gain of approximately \$D. Taxpayer used these proceeds to recover a portion of its CTC.

The tax gain was initially reported as gain from the sale of the generation facilities. In Year 6, Taxpayer filed an amended return for its Year 1 tax year claiming the proceeds in excess of book value received for the plants sold were not includible in gross income in Year 1. The reason proposed in support of its claim was that Taxpayer "was subject to an unequivocal statutory and regulatory obligation to refund the book gain from the sale to ratepayers." Taxpayer reasons that since the gain proceeds offset the CTC that could be charged to ratepayers in subsequent tax years, such gains benefit its ratepayers rather than Taxpayer. Thus, according to Taxpayer, the gain is not includible in gross income until the tax year in which the ratepayers receive a credit on their utility bills for the CTC amount the ratepayers would have otherwise been required to pay. Taxpayer argues that the year in which the ratepayers' bills are credited is the first year in which Taxpayer has a claim of right to the amount, thus making the year the bill is credited the proper year for inclusion of the proceeds.

LAW AND ANALYSIS:

Section 61 defines gross income as "all income from whatever source derived." Section 61(a)(3) specifically refers to "gains derived from dealings in property" as an item of gross income. A taxpayer must recognize the gain from the sale of property, unless the gain is otherwise excluded by law. Section 1.61-6 of the Income Tax Regulations.

The above definition of gross income must be considered in the context of the claim of right doctrine, which has evolved from cases such as *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). In that case, the court held that "[i]f a taxpayer receives

earnings under a claim of right and without restrictions as to its disposition, he has received income" and accordingly must be taxed on it. *Id.* at 424. However, where a taxpayer is obligated to dispose of the money it receives in a certain way, accruing no benefit to itself, the money is not includible in the taxpayer's gross income. See *Central Life Assurance Society v. Commissioner*, 51 F.2d 939, 941 (8th Cir. 1931). Accordingly, for received amounts to be included in gross income a taxpayer must have a claim of right to such amounts and the amounts must be received without restriction.

While the United States Supreme Court has not directly addressed the precise set of facts presented by this case, it has addressed the income tax treatment of amounts received by utilities in other circumstances. In *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), an electric utility ("IPL") required certain customers with suspect credit to make deposits to insure prompt payment of future utility bills. The customer was entitled to a refund of the deposit after making timely payments for several months or satisfying a credit test. The customer could choose to take the refund by cash or check or to apply the refund against future bills. The deposits were commingled with other receipts and at all times were subject to IPL's unfettered use and control. The Service argued that the deposits were advance payments immediately includible in income, while IPL argued they were analogous to loans and, as such, not taxable. The Court reasoned that in economic terms the distinction between advance payments and loans was one of degree rather than kind. *Id.* at 208. While both bestow economic benefits to the recipient, economic benefits qualify as income only if they are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 209, quoting *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). The key to determining whether a taxpayer enjoys "complete dominion" over a given sum is whether the taxpayer "has some guarantee that he will be allowed to keep the money." *Indianapolis Power and Light*, 493 U.S. at 210. The proper focus is on the rights and obligations of the parties at the time the payment was made. *Id.* at 209. Because IPL's customers controlled the ultimate disposition of the deposit and had not committed to purchasing any electricity at the time the deposit was made, the Court found that IPL had no guarantee that it would be allowed to keep the money and held that the deposit amount was not income.

A long line of cases have applied the above principles in determining whether amounts received by a taxpayer are includible in gross income at the time of receipt. These cases have consistently held that when a taxpayer receives funds with an unequivocal statutory or regulatory duty to repay them, thus receiving no economic benefit from the funds, they are not includible in gross income at the time of receipt. In *Mutual Telephone Co. v. United States*, 204 F.2d 160 (9th Cir. 1953), the taxpayer, a telephone utility, was authorized by its regulatory commission to collect additional funds from customers in 1941 and 1942 through increased rates in order to curtail demand. The commission indicated that the additional funds were not being received as additional revenue or collected for the taxpayer's benefit. Also, the amounts collected could not inure to the benefit of the taxpayer's shareholders. Rather, the amounts were paid into

a special account over which the commission held ultimate control until 1949. These additional funds were held to be not includible in the taxpayer's gross income in 1941 and 1942, but includible when made available to the taxpayer in 1949.

In *Illinois Power Co. v. Commissioner*, 792 F.2d 683 (7th Cir. 1986), rate increases collected by the taxpayer utility, pursuant to a state commerce commission's order to discourage consumption, were not includible in gross income in the years received because such increases were not intended to enrich, nor be retained by, the taxpayer. The taxpayer was required to repay these extra amounts to customers in later years even though the customers obtaining the benefit of the repayments were not the same as the customers who paid the increased rates.

A number of recent cases address the tax consequences of fuel overrecoveries to the utilities collecting such overrecoveries. In *Houston Industries, Inc. and Subsidiaries v. United States*, 125 F.3d 1442 (Fed. Cir. 1997), fuel cost overrecoveries received by the utility taxpayer were excludable because the taxpayer had a statutory obligation to repay such amounts to customers. Thus, the taxpayer did not have unrestricted dominion and control over such amounts when received. The Court reasoned that it did not matter whether the amounts were refunded by check to customers or offset against customers' bills because either method had the same effect. In *Florida Progress Corporation & Subsidiaries v. Commissioner*, 114 T.C. 587 (2000), overrecoveries of estimated fuel and energy conservation costs were excludable because the utility did not have complete dominion and control over such amounts upon receipt. Regulatory authority required the taxpayer to return overrecoveries with interest to customers. The repayment mechanism afforded the taxpayer no opportunity to benefit from overrecoveries and the taxpayer was subject to a fixed and certain liability to refund overrecoveries that were determinable when the funds were received. Similarly, in *Cinergy Corp. v. United States*, 55 Fed Cl. 489 (2003), the taxpayer was not required to recognize fuel cost overrecoveries as income when received because (1) it was required to return overrecoveries to its customers; and (2) it lacked complete dominion over the funds, as evidenced by the fact that the time and method of refund was controlled by the regulatory authorities and the taxpayer was required to make monthly reconciliation of these accounts to the regulators.¹ See also *United States v. Maryland Jockey Club of Baltimore City*, 210 F.2d 367 (4th Cir. 1954), *cert. denied*, 347 U.S. 1014 (1954); *Michigan Retailers Association v. United States*, 676 F. Supp. 151 (W.D. Mich. 1988); *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644 (1987); *Broadcast Measurement Bureau, Inc. v. Commissioner*, 16 T.C. 988 (1951); and *Florists'*

¹ In Rev. Rul. 2003-39, 2003-17 I.R.B. 811, the Service accepted the holdings in *Houston Industries*, *Florida Progress*, and *Cinergy Corp.* and concluded that fuel cost and energy conservation cost overrecoveries are not includible in gross income in the year of the overrecovery in cases involving facts substantially similar to those in these three cases.

Transworld Delivery Association v. Commissioner, 67 T.C. 333 (1976).

Citing the foregoing line of cases, Taxpayer argues that the gain proceeds from the sale of generation assets are not includible in gross income in the year of the sale of such assets because the statutory and regulatory scheme established by State requires that such amounts be used to offset the amount of the CTC that may ultimately be billed to ratepayers. Consequently, the mechanism set up under the Decision provides that the economic benefits from the sale of the generation assets inure to the benefit of the ratepayers, not Taxpayer. According to Taxpayer, the gain proceeds have been received by it subject to a substantial restriction. Taxpayer relies on the above cases, for its position that the gain proceeds are not includible in gross income until the ratepayers receive a credit for the CTC they would otherwise have to pay.

In our view, the essence of this case comes down to the fact that Taxpayer is entitled to receive a specified amount, \$E, as the CTC. The amount was determined by measuring Taxpayer's stranded costs. Taxpayer is entitled to recover the \$E from two sources, the ratepayers and / or from plant sales. The CTC from either source constitutes income when received, unless and until Taxpayer receives an amount in excess of the \$E CTC amount it is entitled to receive.² While the CTC recovered from plant sales may not be again recovered from ratepayers, and thus may constitute a benefit of sorts to ratepayers, such factor, at best, is merely incidental to the far more significant, obvious and direct benefit Taxpayer receives: Taxpayer, as permitted by the Decision, received and still retains the proceeds from the plant sales.

Moreover, there are significant differences between the present case and the court cases the Taxpayer cites. First, in the fuel overrecovery cases, the taxpayers collected amounts from ratepayers that they were not, by statute, permitted to keep (thus the use of the term "overrecovery" in the cases). In the present case, Taxpayer did not receive any excess amounts from ratepayers. Instead, Taxpayer received proceeds from an independent third party in a sale transaction, and Taxpayer was entitled to keep all amounts it received from the sale of its plants. Thus, there are no overrecoveries in the case under consideration. In this case, PUC allowed Taxpayer to immediately apply the proceeds from the sale of the plants as a credit to the existing CTC balance identified by Company, thus allowing Taxpayer to immediately receive and recover its transition costs. While the sale proceeds offset the CTC amount the ratepayers would have otherwise had to pay, such offset does not represent a refund of an overrecovery and thus does not affect Taxpayer's requirement to include the gain on the sale of the plants in gross income. In other words, the ratepayers were not the sole source of the CTCs to which Taxpayer was entitled. The proceeds from the plant sales were also a source.

² Hypothetically, if the utility recovered in book gain from plant sales an amount in excess of what it was permitted to recover as the CTC, such excess would not be income to the utility, because Taxpayer would not be entitled to keep it. That would be a situation controlled by *Houston Industries*, and *Florida Progress*.

Such proceeds served as an offset to what could otherwise be levied in the form of rates. They were also, like the rates, includible in income. The same would be true in the case of a taxpayer who performs a service for which he is entitled to \$100 compensation from either Source A or Source B, but not both. In such a case, the taxpayer has gross income of \$100 when Source A makes his required payment even though that payment completely offsets the amount owed by Source B.

Unlike the taxpayers in *Indianapolis Power & Light Co.*, *Houston Industries, Inc.*, and all of their sister cases, Taxpayer in the present case had unrestricted dominion and control over the proceeds from the sale of generation assets when received. The only “detriment” to Taxpayer in receiving its CTC via the sale of its generation assets was that it could not again collect such amount from the ratepayers.

Accordingly, in the present case, proceeds from the sale of Taxpayer’s generation assets are within the meaning of gross income under § 61, were received by Taxpayer under a claim of right, and are required to be included in Taxpayer’s gross income in the year of the sale of the generation assets.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.