

Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.

Overrecovered fuel costs. Taxpayers may exclude fuel cost and energy conservation cost overrecoveries from gross income in cases involving facts substantially similar to *Houston Industries Inc. v. United States*, 32 Fed. Cl. 202 (1994), *appeal on other grounds dismissed*, 78 F.3d 564 (Fed. Cir. 1996), *aff'd*, 125 F.3d 1442 (Fed. Cir. 1997), *Florida Progress Corp. v. Commissioner*, 114 T.C. 587 (2000), and *Cinergy Corp. v. United States*, Nos. 99-750 T and 00-572T (Fed. Cl. filed March 10, 2003).

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The Internal Revenue Service will follow *Houston Industries Inc. v. United States*, 32 Fed. Cl. 202 (1994), *appeal on other grounds dismissed*, 78 F.3d 564 (Fed. Cir. 1996), *aff'd*, 125 F.3d 1442 (Fed. Cir. 1997), and the treatment under § 61 of the Internal Revenue Code of fuel cost and energy conservation cost overrecoveries in *Florida Progress Corp. v. Commissioner*, 114 T.C. 587 (2000). The Service also will follow the treatment under § 61 of fuel cost overrecoveries in *Cinergy Corp. v. United States*, Nos. 99-750 T and 00-572 T (Fed. Cl. filed March 10, 2003). Accordingly, the Service will treat as excludable from gross income fuel cost and energy conservation cost overrecoveries (customer payments in excess of actual fuel and energy conservation costs) in cases involving facts substantially similar to *Houston Industries*, *Florida Progress*, and *Cinergy*.

In *Houston Industries*, the taxpayer billed its customers for electricity according to rates prescribed by the state public utility commission. The rates included a fuel cost component designed to recover the taxpayer's fuel costs. The rates generally were effective for a rate period of at least 12 months, as determined by the public utility commission. Under state law, the taxpayer could retain only its actual fuel costs. On a monthly basis, the taxpayer determined whether it had an overrecovery or underrecovery of its fuel costs. Underrecoveries and overrecoveries were netted against each other to determine the taxpayer's net fuel cost recovery for a rate pe-

riod. Under state law the taxpayer was required to return a net fuel cost overrecovery for a rate period, with interest, by direct payments or credits to the accounts of customers during a subsequent rate period.

The fuel cost components of the taxpayer's rates in effect for rate periods during the years in issue resulted in a net overpayment of fuel costs by the taxpayer's customers. The taxpayer did not include the fuel cost overrecoveries in gross income and deducted the interest accrued on the overrecoveries.

The Court of Federal Claims ruled for the taxpayer. The court concluded that, because the taxpayer had an unconditional obligation to repay to its customers all overrecoveries received, the overrecoveries could not be characterized as income. The Court of Appeals for the Federal Circuit affirmed, noting that the overrecoveries were similar in several respects to the deposits in *Commissioner v. Indianapolis Power and Light Co.*, 493 U.S. 203 (1990). First, the taxpayer derived no benefit from the overrecoveries. The stated purpose of the regulatory scheme that caused the overrecoveries was to benefit the customers, not the taxpayer. Moreover, the taxpayer was required to pay interest on the overrecoveries. Further, the taxpayer had a statutory obligation to repay the overrecoveries at the time it collected its customers' payments. Although an overrecovery could be offset by a later underrecovery, this alternative method of repayment did not affect the taxpayer's obligation to repay.

In *Florida Progress*, the Tax Court held that fuel cost and energy conservation cost overrecoveries under a similar regulatory scheme were excludable from the taxpayer's gross income. The court rejected the Service's argument that the taxpayer held the cost overrecoveries under a claim of right and subject to a conditional obligation to repay only if offsetting underrecoveries did not occur before the end of a rate period. Rather, the court found that the taxpayer had a fixed and certain obligation to refund any overrecoveries, and that offsetting subsequent underrecoveries was merely one means by which the taxpayer met that obligation. Accordingly, the court concluded that the taxpayer did not enjoy com-

plete dominion over the overrecoveries and was not required to recognize them in income.

The Service has concluded, based on the decisions in *Houston Industries*, *Florida Progress*, and *Cinergy* that taxpayers may exclude fuel cost and energy conservation cost overrecoveries from gross income in cases involving facts substantially similar to the above cases.

DRAFTING INFORMATION

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