Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel

(Large Business & International)

from: Senior Technician Reviewer
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subject: Public Utility Exception

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Regulatory Agency =

Statute =

Year 1 =

$A =

Date 1 =

Date 2 =

Date 3 =

Region A =

Court =

Settlement Agreement =

Product A =

Tier 1 =

Period 1 =

Period 2 =

Period 3 =

ISSUE

Whether the Taxpayer was a regulated public utility within the meaning of § 1341(b)(2) of the Internal Revenue Code for the taxable years that include the refund period (as defined below).

CONCLUSION

The Taxpayer was a regulated public utility within the meaning of § 1341(b)(2) for the taxable years that include the refund period.

FACTS

Taxpayer sells Product A through various corporations that file a consolidated federal income tax return.

Because of various physical constraints, until recently the production and sale of Product A in a given region was done by a single vertically integrated provider or a very limited number of providers. To prevent these providers from exercising market power to charge excessive prices, the production and sale of Product A has historically been

subject to extensive state and federal regulation. Under these regulatory regimes, the regulatory body typically approved specific rates at which a particular provider was allowed to sell Product A. These rates were generally designed, though not guaranteed, to allow the seller to recover its reasonably incurred costs plus a specified rate of return (rates determined on a rate-of-return basis).

Recently, vertically integrated providers and sellers of Product A have been broken up and a market-based, competitive system developed to establish the prices at which Product A is sold, in particular the Tier 1 rates for the sale of Product A.

Region A began the process of shifting to a competitive method of determining Tier 1 rates for Product A during Period 1. Competitive bidding among buyers and sellers for Tier 1 sales of Product A began during Period 2. The competitive bidding markets that Region A implemented for Tier 1 sales of Product A generally required that such prices be determined shortly before such products were intended to be used. Consequently, hereafter we will refer to these markets for the Tier 1 sale of Product A as the spot markets. The spot markets were important to trade in Product A because a large portion of the Product A bought and sold for use in Region A was required to be obtained through these markets.

Generally, in a spot market, bids to sell or buy would be ranked and a single market clearing price would be established for all the buyers and sellers in the market. That is, for a given sales period and a given spot market, all sellers of Product A that bid at or below the market clearing price for quantities of Product A would be entitled to receive the market clearing price for those quantities of Product A produced and sold for use during the period covered by the auction.

To qualify to participate in the spot markets sellers had to obtain the permission of Regulatory Agency. Regulatory Agency only approved a seller's participation in the spot markets if it believed the seller would not be able to exercise market power to charge excessive prices. Although prices in the spot markets were determined by bidding among buyers and sellers, Regulatory Agency retained the duty to ensure that the prices charged for Tier 1 sales of Product A were just and reasonable.

Notwithstanding expectations, beginning in Period 3 spot prices for Product A reached prices substantially higher than had been the case in prior periods. In response to a complaint by a buyer of Product A, Regulatory Agency began an investigation to determine the causes of these price increases and to determine if the prices charged were just and reasonable. Regulatory Agency also established a refund period beginning on Date 2 which was subsequent to the initial order. By establishing a refund period, Regulatory Agency put sellers in the spot markets on notice that they might be required to refund some sales proceeds if it determined that the prices charged during the refund period were not just and reasonable. As used in this memorandum, "refund period" refers to the period between Date 2 and Date 3.

Regulatory Agency concluded that there were flaws in the spot markets' structure and rules. The structure of the spot markets also made the markets susceptible to manipulation by sellers of Product A, especially when demand for Product A was high in relation to supply, as had been the case during the marked increase in prices for Product A. Regulatory Agency concluded that prices for Product A had become unjust and unreasonable and that absent some changes might continue to remain unjust and unreasonable. In response to these findings, Regulatory Agency issued a number of orders intended to fix or mitigate the problems in the markets.

To determine the proper amount of refunds due for the refund period, Regulatory Agency initiated processes designed to determine just and reasonable rates for sales of Product A. To do this, Regulatory Agency generally tried to reasonably approximate the prices at which Product A would have sold during the refund period if the spot markets had operated in a competitive manner. These processes involved lengthy investigations and hearings and also involved voluminous comments and input from parties involved in the affected markets. In addition, there were issues regarding the amount of certain production costs that should be taken into account in determining the competitive market price of Product A. Issues arose as to whether sellers of Product A should be allowed to offset certain excluded production costs (that is, costs not taken into account in the formula for determining the competitive market price for Product A) against their refund liability and, if so, how the excluded costs should be calculated. Finally, even if there had been general agreement among the affected parties regarding the methodology to be employed to determine the sellers' refund liability, which there was not, there were also a large number of factual disputes that added more complexity to the process.

Ultimately, Regulatory Agency and Taxpayer entered into a Settlement Agreement regarding a number of claims asserted against Taxpayer arising from Taxpayer's participation in the relevant markets for Product A. Among the issues settled was Taxpayer's obligation to return amounts earned from the sale of Product A during the refund period. Pursuant to the Settlement Agreement, Taxpayer was required to write off $A of receivables as a repayment of amounts previously reported as gross income from the sale of Product A during the refund period. For Year 1, Taxpayer has claimed the tax benefits of § 1341 with respect to the receivables that have been written off. Exam asserts that § 1341 does not apply because Taxpayer is not a regulated public utility for purposes of § 1341.

LAW AND ANALYSIS

Section 1341

To qualify for the tax benefits of § 1341 a taxpayer must satisfy the following three requirements of § 1341(a):

(a)(1) the taxpayer must have included an item in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item,

(a)(2) a deduction must be allowable to the taxpayer for the current taxable year because it was established after the close of the taxable year (or years) of income inclusion that the taxpayer did not have an unrestricted right to the item or portion thereof, and

(a)(3) the amount of the deduction must exceed $3,000.

When it applies, § 1341 imposes on the taxpayer the lesser of:

> (1) the normal income tax for the year in which excess income is restored by the taxpayer with a deduction for the amount restored (§ 1341(a)(4)), or
>
> (2) a tax computed for the current taxable year without the deduction for the restored item of income but with a reduction in tax equal to the amount that the tax for the year in which the taxpayer received the excess income would have been decreased if the amount restored had been excluded from income in that year. Section 1341(a)(5).

The Inventory Rule and the Public Utility Exception

Even if the requirements of § 1341(a)(1)-(3) are satisfied, the tax benefits of § 1341 are denied for deductions that fall within the inventory rule of § 1341(b)(2). The inventory rule of § 1341(b)(2) denies the tax benefits of § 1341 to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. For purposes of this memorandum we assume that Product A is inventory subject to the inventory rule of § 1341(b)(2).

However, an exception to the inventory rule applies in the case of certain refunds required to be made by regulated public utilities (the public utility exception). Specifically, § 1341(b)(2) provides an exception to the inventory rule if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility (as defined in section 7701(a)(33) without regard to certain gross income tests pertaining to revenue from regulated rates contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

Section 7701(a)(33) defines a regulated public utility in part as a corporation engaged in the furnishing or sale of certain items, including Product A, if the rates for the sale of such items have been established or approved by certain entities. Regulatory Agency qualifies as one of the entities referred to in the statute. The remaining issue to be resolved is whether any deduction that arises out of the refunds at issue is allowable with respect to rates that have been established or approved by Regulatory Agency.

Congress added § 1341 when it enacted the Internal Revenue Code of 1954. The initial House reported version of the bill did not contain the public utility exception. However, several people who testified at the Senate hearings on the proposed legislation advocated for the inclusion of a public utility exception to the inventory rule because public utilities' rates were frequently subject to regulatory review and utilities would not qualify for the adjustment provided under the now-repealed § 462 (allowing an accrual basis merchant or manufacturer to charge refunds against reserves for estimated expenses).[1]

The Senate Report to the 1954 Act provides:

> Your committee has provided that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility (as defined in § 1503(c)) if such refunds or repayments are required to be made by the government, political subdivision, agency or instrumentality referred to in such section. Thus refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

S. Rep. No. 1622, 83d Cong. 2d Sess. 452 (1954).

Congress enacted § 1341 and the predecessor to § 7701(a)(33) (§ 1503(c) of the 1954 Code) when it was understood that a regulated public utility's rates were determined on a rate-of-return basis. However, there is nothing in the statutory language of § 7701(a)(33) nor in the legislative history to the 1954 Act that limits "established or approved" rates to rates determined on a rate-of-return basis.

Sellers of Product A had to obtain authorization from Regulatory Agency to sell at market-based rates in the spot markets. A seller's "tariff" for these markets did not consist of filed rates at specific amounts but rather a set of rules that had to be followed by market participants in determining the price of Product A. We do not believe that an authorization to sell at market-based rates in a market that is governed by a detailed set

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[1] *The Internal Revenue Code of 1954: Hearings Before the Committee on Finance United States Senate,* 83d Cong., 2d Sess. *on H.R. 8300,* 1049 (Statement of Edison Electric Institute, New York, N.Y.); see also Statement of Committee of Executives on Taxation of the American Gas Association, New York N.Y. at 1232-1233 (recommending same language change for the same reasons); Statement of I.M Avent, Attorney, Independent Natural Gas Association at 1284 (recommending a similar language change).

of rules in and of itself results in "established or approved" rates within the meaning of § 7701(a)(33).

However, in the instant case Regulatory Agency was under a continuing statutory obligation to ensure that the market-based rates were just and reasonable. See Statute. When Regulatory Agency became aware that there might be problems that caused the rates charged not to be just and reasonable, Regulatory Agency investigated the operation of the spot markets. With respect to the amounts at issue, by establishing the refund period on a prospective basis, Regulatory Agency put Taxpayer and other sellers of Product A on notice that they might be required to refund some of their proceeds from sales of Product A made during the refund period.

When Regulatory Agency determined that the rates charged for the refund period were not just and reasonable, Regulatory Agency started a lengthy process to determine specific rates for the sale of Product A for periods during the refund period that would satisfy the just and reasonable standard. To determine just and reasonable rates for the refund period, Regulatory Agency generally attempted to determine what market-based rates would have been if the spot markets had operated in a competitive manner rather than adopting a rate-of-return approach. To determine what these rates would have been Regulatory Agency used economic theory rather than observations of independent market prices. Granted, there was probably no independent comparable market for Product A from which Regulatory Agency could have obtained market quotes. However, Regulatory Agency's use of economic theory rather than observations of independent comparable market prices supports the conclusion that Regulatory Agency was taking active steps to establish or approve the just and reasonable price. Furthermore, had this process completely run its course, Regulatory Agency would have made a determination of specific rates for the legal sales prices for Product A during the refund period.

We believe this is enough to satisfy the "established or approved" requirement of § 7701(a)(33). We recognize that it is necessary to interpret existing statutes to further congressional intent in light of changing circumstances. The result we reach is consistent with the purpose of the regulated public utility exception to the inventory rule as reflected in § 1341's legislative history. As enacted, the exception was meant to allow utilities to obtain § 1341 tax benefits for refunds of amounts collected under temporary rates that were subject to later adjustment when made final. This is exactly what happened in the instant case. Although the temporary rates in the instant case were not specifically set by Regulatory Agency, with respect to the refund period Regulatory Agency exercised its statutory duty to establish or approve final just and reasonable rates for the period. The refunds that Taxpayer made were with respect to these rates within the meaning of § 1341(b)(2). Regulatory Agency has the authority to resolve issues through settlement and the rates are no less established or approved by Regulatory Agency because the refund obligation was resolved by settlement.

Therefore, we conclude that the Taxpayer was a regulated public utility within the meaning of § 1341(b)(2) for the taxable years that include the refund period.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4960 if you have any further questions.

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