Internal Revenue Service

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, No.

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Refer Reply To:
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Date:
September 25, 2008

LEGEND:

Taxpayer	=		
LX	=		
State X PUC	=		
State Y PUC	=		
Parent	=		
Buyer	=		
Units	=		
Year X	=		
Date 1	=	Date 4	=
Date 2	=	Date 5	=
Date 3	=	Date 6	=

Dear

This responds to your request for a private letter ruling, dated January 24, 2008. Specifically, you have asked us to rule that, under § 61 of the Internal Revenue Code, certain amounts in a segregated fund derived from a disposition of property are not includible in Taxpayer's gross income.

FACTS:

A. Background

Taxpayer is organized as a State X public electric utility subject to the regulatory jurisdiction of State X PUC, State Y PUC and the Federal Energy Regulatory Commission (FERC). Taxpayer is a wholly-owned subsidiary of Parent and joins in the consolidated federal income tax return filed for the affiliated group of Parent on a calendar year basis. Taxpayer and Parent use the accrual method of accounting.

Prior to the sale transaction discussed in this ruling request, Taxpayer was the owner of LX. LX consists of two units (Unit 1 and Unit 2), and includes supporting facilities which serve each of the two units to an equal degree.

B. The Transaction

On Date 1, Taxpayer and Buyer entered into an Asset Sale Agreement (ASA) whereby Buyer agreed to purchase Unit 1 and Unit 2 of LX. The ASA was made subject to the satisfaction of certain conditions and receipt of approvals by various governmental authorities, including the approval of the aforementioned regulators. Taxpayer represents that it sold LX for the benefit of its customers. State X PUC approved the sale because it determined that Buyer could operate LX more efficiently than Taxpayer.

To assure that the sale benefited its customers, Taxpayer agreed with the regulatory commissions that any book gain (the excess of the amount paid by Buyer for LX over Taxpayer's adjusted basis in LX as determined for financial accounting purposes) on the sale of LX and the excess decommissioning proceeds[1] would accrue to the benefit of its customers. While the details of this agreement were not spelled out at the time the sale was negotiated, the mandate that the customers rather than Taxpayer would benefit from the book gain and the excess decommissioning proceeds was established prior to the commencement of any negotiations for the sale of LX and prior to the approval requests filed with the regulatory commissions.

State X PUC and State Y PUC each issued their orders approving the sale of LX on Date 2. FERC issued its order approving the sale on Date 3. State X PUC, in its sale order, granted approval for the sale in accordance with the terms of the ASA, as modified by certain conditions that it imposed. However, State X PUC delayed making a decision as to the proper disposition of the book gain from the sale and the excess decommissioning proceeds subject to its jurisdiction until a later State X PUC proceeding.

The sale of LX closed on Date 4. At closing, Buyer transferred the sale proceeds to a segregated bank account (the Segregated Fund). The trustee of the nuclear decommissioning funds pertaining to LX similarly managed the sale of the assets in the decommissioning funds and deposited the portion of the funds that were not to be transferred to Buyer in the Segregated Fund.[2] As authorized by the regulators,

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[1] The term "excess decommissioning proceeds" refers to the gain portion of Taxpayer's non-qualified decommissioning funds (NQDF's). Taxpayer's NQDF's were not transferred to Buyer as part of the sale of LX. Rather, those amounts were required by the regulators to be refunded to customer. Moreover, to the extent the NQDF held investments in stock or other securities, the securities were required to be sold prior to the customer refunds. Taxpayer believes that the gain on such sales is not includible in gross income on the same grounds that it asserts for not including book gain from the sale of LX.

[2] Prior to the sale, Taxpayer maintained two qualified decommissioning funds and four nonqualified decommissioning funds. Only a portion of the assets of the qualified decommissioning funds was

Taxpayer removed an amount from the Segregated Fund equal to its book basis in LX (Taxpayer's adjusted basis in LX as determined for financial accounting purposes). The proceeds that remained in the Segregated Fund (the remaining Segregated Fund amount) designated to be refunded to customers consist of (A) the book gain attributable to the sale of LX and (B) the decommissioning proceeds required to be refunded to customers, less (C) the costs incurred by Taxpayer in connection with the sale (the "transaction costs").[3] Also, all of the interest earned on the net proceeds that accumulates in the Segregated Fund is for the benefit of customers.

On Date 5, State X PUC issued an interim order regarding the remaining Segregated Fund amount allocable to Taxpayer's State X customers. The interim order provided as follows:

1. The book gain from the sale of LX shall be segregated from the internal funds of the utility and not co-mingled with other utility funds;

2. Taxpayer shall refund all of the remaining Segregated Fund amount and any interest relating to such amount to customers in accordance with a plan approved by the Commission; and

3. The Segregated Fund shall remain under the oversight of the commission until the entirety of the fund is fully distributed to customers.

On Date 6, State X PUC issued a final order regarding the remaining Segregated Fund amount allocable to State X customers. The final order provided that such amount would be returned to Taxpayer's customers entirely though bill credits provided over a three-year period. In addition, State Y PUC ordered that the portion of the remaining Segregated Fund amount allocable to State Y customers be refunded to customers as a bill credit over an 18-month period. Finally, FERC ordered that the remaining Segregated Fund amount allocable to FERC customers be refunded in a one-time payment via either check or a bill credit in Year X.

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transferred to Buyer in the sale and none of non-qualified funds were transferred to Buyer. All of the non-qualified decommissioning funds and a portion of the qualified decommissioning funds are being refunded to customers (and are held in the Segregated Fund). However, Taxpayer has asked for a ruling only with respect to the portion of such refund consisting of the gain derived from the sale of securities held by the non-qualified decommissioning funds.

[3] The transaction costs include out-of-pocket expenses that were incurred in evaluating strategic options for LX, the costs of conducting the auction process used in the sale, such as fees and expenses of attorney and consultants who assisted in soliciting and evaluating bids, negotiating the transaction, drafting the documents and other activities directly associated with the sale. Transaction costs also included the cost of obtaining regulatory approvals, terminating a relationship with the operator of LX, and of transferring employees to the new owner of LX.

Taxpayer has requested rulings that the portion of the remaining Segregated Fund amount consisting of the book gain from the sale of LX, plus the gain portion of the decommissioning funds, less the aforementioned transaction costs, and the interest that accrues on the amounts in the Segregated Fund are not includible in Taxpayer's gross income.

LAW AND ANALYSIS:

Section 61 of the Code 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. Under § 1.61-6(a) of the Income Tax Regulations, gain realized on the sale or exchange of property is included in gross income, unless excluded by law.

Section 1001(a) provides that a taxpayer's gain from a sale of property is the excess of the amount realized on the sale over the adjusted basis of the property sold. Under § 1001(b), the amount realized from a sale of property is the sum of money received plus the fair market value of the other property received. In general, gain must be recognized in the year of sale unless a provision of the Code provides otherwise.

In the present case, the taxpayer has requested a ruling that the book gain is not taken into account in determining gain on the sale of LX and thus not included in Taxpayer's gross income. The taxpayer argues that the book gain, while paid by Buyer, was not received by Taxpayer because the book gain was required to be placed in the Segregated Fund and the taxpayer was obligated to refund it, with interest, to its customers. For the same reasons, Taxpayer also asks that we rule that the gain derived from decommissioning funds and the interest accruing on the amounts in the Segregated Fund are not required to be included in the taxpayer's gross income.

North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932), holds that amounts received under a claim of right and without restriction as to their disposition constitute income in the year of receipt, even though the taxpayer later might be required to restore an equivalent amount. However, where a taxpayer is obligated to dispose of the money it receives in a certain way, accruing no benefit to itself, the funds are not includible in the taxpayer's gross income. *See Central Life Assurance Society, Mutual v. Commissioner,* 51 F.2d 939, 941 (8th Cir. 1931). Accordingly, for amounts to be included in gross income, the taxpayer must have both a claim of right to such amounts and they must be received without restriction. The Supreme Court has consistently upheld the claim-of-right doctrine. *See, e.g., United States v. Lewis*, 340 U.S. 590 (1951); and *Healy v. Commissioner*, 345 U.S. 278 (1953). A similar analysis applies in determining whether a taxpayer received an amount for purposes of determining the taxpayer's gain on a sale of property.

In the present case, the book gain amount paid by Buyer from the sale of LX, along with the gain derived from the decommissioning funds, were not received under a claim of right or without restriction as to their disposition. From the beginning, when the regulators approved the sale of LX, it was always understood by the regulators and Taxpayer that all of these gains were the property of the customers and that only the customers would enjoy the economic benefit of those gains. These amounts were set aside and the taxpayer was always accountable to the regulator for the way in which they were administered and distributed. In addition, even the interest derived from these proceeds must be paid to the customers. With respect to the excess decommissioning proceeds, Taxpayer was also required, prior to the sales that generated the excess decommissioning proceeds, to place such amounts in the Segregated Fund so it could be refunded, with interest, to customers.

Consistent with the holding of *North American Oil Consolidated*, the Supreme Court has also stated that economic benefits qualify as income if they are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

In the present case, there is no evidence of the existence of any economic benefit derived by Taxpayer in the book gain from the sale or the excess decommissioning proceeds. The three characteristics of income mentioned in *Glenshaw Glass* are lacking. Because it is the customers who are entitled to the book gain from the sale of the LX units, the excess decommissioning proceeds (and the interest on such amounts earned in the Segregated Fund), it can hardly be maintained that Taxpayer has received an accession to wealth that was clearly realized. Under the rules set out by the regulators, these amounts are those of the customers, not of Taxpayer. Also, because of the regulators' control over the money while retained in the Segregated Account and their required remittance in the form of bill credits and by cash payments to customers, Taxpayer lacks complete dominion over these funds.

Indianapolis Power & Light, 493 U.S. 203 (1990), is an example of the application of the principle that an amount is not received by a taxpayer as its income unless the amount is an undeniable accession to wealth, clearly realized, and over which the taxpayer has complete dominion. In *Indianapolis Power*, an electric utility (Indianapolis Power & Light or "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 the deposits were advance payments immediately includable in income. IPL argued they were analogous to loans and as such not taxable. The Court reasoned that 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., supra*. 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 & Light* 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.

Many cases have applied the above principles discussed in *Indianapolis Power* in determining whether amounts received by a taxpayer are includible in gross income at the time of receipt. These cases have consistently held that funds received by a taxpayer with an unequivocal statutory or regulatory duty to repay them, and without the taxpayer otherwise receiving any economic benefit, are not includible in gross income. In *Mutual Telephone Co. v. United States,* 204 F.2d 160 (9th Cir. 1953), 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 in the form of bill credits, even though the customers obtaining the benefit of the repayments were not the same customers who had paid the increased rates. This result was based on the rationale that the utility was only a “custodian” of these overcharges “with no greater beneficial interest in the revenues collected than a bank has in money deposited with it.” *Id.* at 689. From the time that the overcharge was first ordered in 1974, it was clear to all parties that these amounts could not be retained by the taxpayer.

A number of cases address the tax consequences of fuel overrecoveries to the utilities collecting them. In *Houston Industries, Inc. and Subsidiaries v. United States,* 125 F.3d 1442 (Fed. Cir. 1997), fuel cost overrecoveries received 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, as in the present case with the book gain on the sale of LX. The repayment mechanism afforded the utility no opportunity to benefit from overrecoveries and the utility 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.[4] *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' Transworld Delivery Association v. Commissioner*, 67 T.C. 333 (1976).

These cases may be contrasted with *Iowa Southern Utilities Co. v. United States,* 841 F.2d 1108 (Fed. Cir. 1988), *cert. denied,* 488 U.S. 952 (1988), in which surcharges paid by customers to finance construction of a power plant were includible in the utility's taxable income. The court so held even though the surcharges were to be "unconditionally refunded" as a matter of "regulatory policy" over a 30-year period to customers, through rate reductions, after the plant's construction. *Id.* at 1111. These amounts were income to the utility because (1) the court identified no "unequivocal contractual, statutory, or regulatory duty to repay;" (2) the taxpayer had no duty to pay interests on the amounts collected; (3) the taxpayer was using the money so derived to fund plant construction (and so was more than a mere custodian); and (4) the taxpayer "obviously . . . benefited from the transaction." *Id* at 1112.

The facts of the present case bear greater similarity to those of *Mutual Telephone Co. v. United States, Illinois Power Co. v. Commissioner* and *Indianapolis Power & Light* than to *Iowa Southern Utilities Co.* The book gain derived from the sale of LX was reserved from the beginning in the regulatory orders approving the sale for the benefit of the

[4] 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.

customers and not Taxpayer. Also, the gain derived from the decommissioning funds and the interest in the Segregated Fund accrued to the benefit of the customers. These amounts will be paid to the customers, and not to Taxpayer. Under these circumstances the book gain amounts, the gain from the decommissioning funds, and interest attributable to such amounts, were not received under a claim of right. Nor were they "undeniable accessions to wealth, clearly realized, and over which [Taxpayer had] complete dominion."

RULING:

Based on the facts submitted and the representations made, we rule as follows:

The amounts in the Segregated Fund consisting of (1) the book gain from the sale of LX, and (2) the gain from decommissioning funds are not taken into account in determining Taxpayer's gross income under § 61. In addition, interest that accrues on such amounts while in the Segregated Fund is not includible in gross income.

CAVEAT(S):

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)

Enclosure(s)