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TY:

Taxpayer =

Predecessor =

Parent 3 =

Parent 2 =

Former Parent =

Partnership =

Corporation 1 =

Corporation 2 =

Corporation 3 =

Business A =

Production Assets =

Primary Claimant =

Entity A =

Entity B =

Entity C =

Member D =

Regulatory Agency =

A# =

Month 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

$A =

$B =

$C =

$D =

$E =

$F =

$G =

$H =

$I =

$J =

$K =

$L =

$M =

$N =

$O =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

State A =

A% =

B% =

Settlement Agreement =

Product A =

Subproduct A1 =

Subproduct A2 =

Tier 1 =

Rate Agreements =

Bankruptcy Court =

Period 1 =

Period 2 =

Period 3 =

Period 4 =

Dear :

This letter responds to Parent 3's request for a ruling regarding the application of section 1341 to amounts paid to settle certain claims asserted against members of an affiliated group (or their predecessors) of which Parent 3 is the common parent (Taxpayer). Taxpayer files a consolidated federal income tax return.

Taxpayer engages in Business A. Prior to Date 1, Parent 2, a predecessor of Parent 3, and its subsidiaries were members of Group 1, an affiliated group of corporations with Former Parent as the common parent. Group 1 filed a consolidated federal income tax return. On Date 1, Former Parent distributed the common stock it held in Parent 2 to Former Parent shareholders. The Service ruled that under section 355(c) no gain or loss would be recognized to Former Parent upon the distribution of Parent 2 stock to Former Parent shareholders. The Service also ruled that under section 355(a)(1) no gain or loss would be recognized by Former Parent's shareholders upon their receipt of Parent 2 stock.

After the Service issued this ruling, certain events caused Former Parent to request supplemental rulings from the Service. In the supplemental ruling request Former Parent represented that pursuant to arms-length agreements between Former Parent and Parent 2, Former Parent directly and indirectly contributed cash to Parent 2 to defray certain expenses that Parent 2 incurred in connection with a public offering of Parent 2 stock prior to the spin-off and the various distributions made in connection with the spin-off (the "Capital Contribution"). In the supplemental PLR the Service ruled that the Capital Contribution transferred by Former Parent to Parent 2 in constructive exchange for additional shares of Parent 2 common stock, followed by Former Parent's distribution of all of its Parent 2 common stock constituted a reorganization within the meaning of section 368(a)(1)(D). The Service also ruled that Former Parent and Parent 2 would each be a "party to a reorganization" within the meaning of section 368(c).

In addition, the Service modified its prior ruling that under section 355(c) no gain or loss would be recognized by Former Parent upon its distribution of Parent 2 stock to Former Parent's shareholders. The prior ruling was modified to provide that under section

361(c)(1) no gain or loss would be recognized by Former Parent upon the distribution of Parent 2 stock to Former Parent's shareholders.

During Year 1 and Year 2, Entity A and Entity B were disregarded entities for federal income tax purposes that were treated as part of Partnership. Partnership had two corporate partners, Corporation 1 and Corporation 2, each of which owned a 50% interest in Partnership. Corporation 1 and Corporation 2 were members of Group 1 during this period. In Month 1, Corporation 2 merged into Corporation 1 resulting in the liquidation of Partnership. Following the merger, for federal income tax purposes Entity A and Entity B were disregarded entities not treated as separate from their owner, Corporation 1. Sometime in Year 3 Corporation 1 changed its name to Corporation 3.

State A began the process of shifting to a competitive method to determine Tier 1 rates for Product A during Period 1. Competitive bidding among producers of Product A began during Period 2. Because of various physical constraints, it was necessary for certain producers of Product A to supply Product A at certain times irrespective of bid. To implement this requirement, certain producers of Product A were required to enter into Rate Agreements pursuant to which they received a form of regulated rather than purely competitive market price for Product A during certain periods.

Entity A and Entity B sold Product A.[1] Disputes arose regarding the proper share of certain Entity A and Entity B costs that should be recoverable by those entities through charges for Product A under the Rate Agreements (the cost share issue). Entity A and Entity B collected amounts for Product A pursuant to the Rate Agreements subject to the obligation to refund, with interest, any amounts that were subsequently determined to be excessive.

In a Date 2 decision, a Regulatory Agency administrative law judge issued an initial decision with a supporting opinion regarding the proper method to determine recoverable amounts pertaining to the cost share issue. Pursuant to the decision, amounts previously collected by Entity A and Entity B with regard to the cost share issue would have been excessive. However, Regulatory Agency never issued a final ruling definitively resolving the issue.

After Parent 2's spin-off from Group 1, the consolidated group headed by Parent 2 (Group 2), experienced financial difficulties. On Date 3 and various dates thereafter, Parent 2 and A# of its direct and indirect subsidiaries filed voluntary bankruptcy petitions under Chapter 11 of the United States Bankruptcy Code. Entity A and Entity B also participated in the bankruptcy filings. Although various members of Group 2 were

[1] Entity A and Entity B each had names differing from their current name while associated with members of Group 1. To simplify the discussion, the entities in question will only be referred to in this memorandum as Entity A and Entity B.

placed in separate groups for some bankruptcy purposes, all or the vast majority of the bankruptcy cases were jointly administered[2].

During the bankruptcy proceedings, Primary Claimant filed a proof of claim (Proof of Claim 1) against Entity A seeking a total of $A. This amount consisted of $B relating to claims for overcharges relating to the cost share issue for Period 3, $C for certain invoice disputes relating to sales of Product A pursuant to the Rate Agreements, $D relating to the recovery of certain costs in providing Product A, $E for claimed overcharges pertaining to Rate Agreements applicable to Year 4, and $F for interest through Date 4 on the $B and $C claims.

Primary Claimant also filed a proof of claim (Proof of Claim 2) against Entity B seeking a total of $G. This amount consisted of $H relating to claims for overcharges relating to the cost share issue for Period 4, $I for certain invoice disputes relating to sales of Product A pursuant to the Rate Agreements, $J for claimed overcharges pertaining to Rate Agreements applicable to Year 4, and $K for interest through Date 4 on the $H and $I claims.

On Date 5, relevant members of Group 2 and others entered into a Settlement Agreement with various parties. Pursuant to the Settlement Agreement, Primary Claimant and relevant members of Group 2 and others agreed to resolve all claims relating to Rate Agreements arising from circumstances prior to or including Date 6. Regulatory Agency approved the Settlement Agreement on Date 7. The Bankruptcy Court approved the Settlement Agreement on Date 8 making it effective on that date.

The Settlement Agreement entitled Primary Claimant to a distribution of money and/or other property with respect to Proofs of Claim 1 and 2. Specifically, the Settlement Agreement entitled Primary Claimant to a bankruptcy claim in Entity A's reorganization plan of $L in cash and/or securities To the extent this amount was paid through the issuance of securities, the Settlement Agreement obligated Primary Claimant to sell the securities in a commercially reasonable manner designed to maximize their liquidated value. To the extent the sum of the net amounts received from security sales plus cash fell short of the $L, the Settlement Agreement entitled Primary Claimant to recover the shortfall by taking credits against charges of Entity A for the provision of valuable consideration to Primary Claimant in the future. In addition, Entity A could elect to eliminate any shortfall through a cash payment. Finally, the Settlement Agreement obligated Entity C to pay the shortfall in cash if not otherwise satisfied through the foregoing procedures within a specified time period.

On Date 9, the Bankruptcy Court approved and confirmed a bankruptcy reorganization plan (the plan) for the members of Group 2 and others. That plan required Parent 2 to

[2] In the remainder of this memorandum, references to Group 2 in the context of the bankruptcy reorganization plan refer to those Group 2 members and others covered by the plan.

change its name[3] and to transfer substantially all of its assets to Parent 3 or one or more subsidiaries of Parent 3. The liabilities of Parent 3 and its subsidiaries post-reorganization (Taxpayer) were as specified in the plan. Pursuant to the plan, Taxpayer continued the business operations previously conducted by Group 2 prior to the reorganization. The plan also required various asset transfers and organizational changes within Taxpayer below the level of Parent 3. Taxpayer has represented that this reorganization qualified as a reorganization within the meaning of section 368(a)(1)(G). The Service did not issue a ruling on this issue.

In addition to the $L cash and/or securities previously discussed, the Settlement Agreement also entitled Primary Claimant to receive either the Production Assets from Entity A and Member D or cash and/or securities of either $M or $N depending on the circumstances.

The distribution of $L to Primary Claimant, made on or about Date 10, consisted of A% cash and B% stock in Parent 3. In accordance with the Settlement Agreement, Primary Claimant liquidated the Parent 3 stock. To the extent the net amount realized from the sale of the stock was less than the stated amount of the distributions, the shortfall was made up by payment from either Entity A or Entity C or from withholding of payments by Primary Claimant through the crediting mechanism discussed above.

On or about Date 11, Primary Claimant elected to close on the transfer of the Production Assets to Primary Claimant. At the time of closing the Production Assets had a fair market value of $O. The issue to be resolved is whether Taxpayer may obtain the benefits of section 1341 with regard to the amounts transferred to Primary Claimant.

LAW AND ANALYSIS

Section 1341

To qualify for the tax benefits of section 1341 a taxpayer must satisfy the following three requirements of section 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

[3] All existing equity interests in Parent 2 were cancelled and new equity interests in Parent 2 were issued for the benefit of certain parties. Parent 2 retained only a small fraction of the assets previously owned. All assets necessary for the operation of the future reorganized business operations were transferred to Taxpayer.

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

When it applies, section 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 (section 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).

Section 381

Section 381(a) provides that in the case of certain acquisitions of assets of a corporation by another corporation, the acquiring corporation succeeds to certain tax attributes of the transferor corporation listed in section 381(c), determined as of the close of the day of distribution or transfer, subject to the conditions and limitations specified in section 381(b) and 381(c). Section 381(c) does not expressly list the ability to use section 1341 with respect to the disgorgement, by the acquiring corporation, of an item previously included in gross income in a prior taxable year by the transferor corporation. Nevertheless, the Service has ruled that the right (in reality, the right of the acquiring corporation to treat the section 1341(a)(1) requirement as satisfied by the transferor corporation's previous inclusion of an item in gross income under a claim or right) to the tax benefits of section 1341 may transfer to the acquiring corporation under section 381(c)(16). Rev. Rul. 71-496, 1971-2 C.B. 315 (Where M was merged into P in 1970 pursuant to a reorganization qualifying under section 368(a)(1)(A), P was allowed to compute tax liability under section 1341 where it was required to refund to the government subsidy payments that M received and included in gross income under a claim of right for 1968, and the amount of stock exchanged by P pursuant to the reorganization did not reflect the obligation to refund the subsidy payments)[4].

A carryover of tax attributes from the transferor to the acquiring corporation may occur in a corporate liquidation under section 332 (section 381(a)(1)) or in a transfer of corporate assets to which section 361 applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F) or (G) of section

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[4] Although the revenue ruling technically only addresses a situation in which the requirements of section 381(c)(16) are satisfied, the same result applies where the amount is deductible in accordance with the section 381(c)(4) regulations. If a liability is assumed by the acquiring corporation and section 381(c)(16) does not apply, than section 381(c)(4) will apply. In either event, the acquiring corporation essentially steps into the shoes of the transferor corporation with respect to the character of the deduction. *See* Treas. Reg. § 1.381(c)(4)-1(a)(1)(ii).

368(a)(1). However, in the case of a reorganization under section 368(a)(1)(D) or (G), the transfer of tax attributes occurs only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are satisfied. Section 381(a)(2).

The requirements of section 354(b)(1)(A) and (B) are satisfied only if:

(1) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(2) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Consequently, section 381 does not allow the transfer of corporate tax attributes from one corporation to another in either (D) or (G) reorganizations where the property transfers result from corporate divisions.

Finally, notwithstanding the above, Treas. Reg. § 1.381(a)-1(b)(3)(i) states:

> Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

Partnership Provisions

Section 701 provides that a partnership as such shall not be subject to the income tax imposed by chapter 1 of the Internal Revenue Code (the Code). Instead, persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities. In determining their taxable income, section 702(a) requires partners to take into account their distributive share of various items of partnership income, gain, loss, deduction, and credit. Where the character of a partner's distributive share of items of income, gain, loss, deduction, or credit could be important to the determination of the partner's tax liability, section 702(b) requires the character of such distributive share to be determined as if realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Section 702(c) provides that where it is necessary to determine the gross income of a partner for purposes of the Code, such amount shall include the partner's distributive share of the gross income of the partnership.

Does Taxpayer Succeed to the Section 1341 Tax Attribute?

Entity A and Entity B generated items of gross income attributable to sales of Product A pursuant to the Rate Agreements. While these entities were part of Partnership, for section 1341(a)(1) purposes the items were includible in the gross income of the partners, Corporation 1 and Corporation 2, based on their respective distributive shares of such gross income. For periods when these entities were treated as entities not separate from their corporate owners, for section 1341(a)(1) purposes the items were includible in the gross income of their corporate owners.

A portion of these amounts were subsequently required to be restored to Primary Claimant pursuant to the Settlement Agreement. Some of the amounts at issue were includable in the gross income of members of Group 1 (during the pre-spinoff period) and some of the amounts at issue were includible in the gross income of one or more members of Group 2 (during the post-spin-off period). However, the refunds occurred after the bankruptcy reorganization. Assuming that the corporations that included the relevant amounts in gross income satisfied section 1341(a)(1)'s requirement that an item have been included in gross income in a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item, the question remains as to whether Taxpayer obtains the benefit of this tax attribute. Although the tax attribute in question is technically satisfying the requirements of section 1341(a)(1), to simplify the discussion we will refer to this tax attribute as the section 1341 tax attribute.

For amounts included in gross income attributable to the pre-spin off period, the first question is whether the section 1341 tax attribute left Group 1 and attached to Group 2 or one or more of its members following the spin-off. The supplemental PLR classified the direct and indirect transfer of cash to Parent 2 followed by the distribution of Parent 2 stock to Former Parent shareholders as a section 368(a)(1)(D) reorganization. Because of this, Taxpayer argues in part that under Rev. Rul. 71-496, Parent 2, and by implication Group 2, succeeded to any section 1341 tax attribute originally attached to Group 1.

However, it is clear that Parent 2 or Group 2 as a whole did not succeed to the section 1341 tax attribute under section 381. Because Former Parent did not transfer substantially all of its property to Parent 2, the direct and indirect transfer of cash to Parent 2 followed by the spin-off constituted a divisive reorganization that did not satisfy the requirements of section 354(b)(1)(A), making section 381 inapplicable. However, this conclusion does not end the analysis.

No consolidated return regulations expressly address the application of section 1341. Most importantly, no consolidated return regulations address how section 1341 applies when a member leaves a consolidated group and then is subsequently required to disgorge income earned while it was a member of that group. Nevertheless, Treas. Reg. § 1.1502-80 generally provides that the Code (which includes section 1341), or other law, shall be applicable to the group to the extent the regulations do not exclude its application.

Disregarding the $3,000 requirement in section 1341(a)(3), there are two primary requirements that must be satisfied for section 1341 to apply:

(1) the taxpayer must have included an item in gross income for a prior taxable year or years under a claim of right, and

(2) the taxpayer must be entitled to a deduction in the current taxable year because the taxpayer is under a legal obligation to disgorge all or a portion of the item included in gross income for the prior taxable year or years.

Treas. Reg. § 1.1502-11(a)(1) makes the first step in computing consolidated taxable income taking into account the separate taxable income of each member of the group. With certain exceptions not relevant here, Treas. Reg. § 1.1502-12 provides that the separate taxable income of a member of a consolidated group (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations.

Computing the separate taxable income of a member of the group requires separately taking into account that member's gross income and that members' deductions from gross income. If a member includes an item in gross income under a claim of right, that item of gross income is taken into account in determining the member's separate taxable income. Likewise, where the member is entitled to a deduction in a later taxable year for disgorging all or a portion of that item of gross income, the deduction is taken into account in computing the member's separate taxable income. Although there are some items of income and deduction that the consolidated return regulations require to be computed on a consolidated basis, the regulations do not impose such a requirement for the items at issue in this case.

Admittedly, the tax benefits of section 1341 reduce the consolidated tax liability of the entire group. However, because both of the essential elements necessary to qualify for the tax benefits of section 1341 are taken into account in computing a member's separate taxable income, the section 1341 tax attribute constitutes a tax attribute of the individual member rather than a tax attribute that attaches to the group when the item is included in gross income. Because neither Former Parent nor the members of Group 1 that remained with Former Parent after the spin-off had any liability to disgorge the amounts at issue, treating the section 1341 tax attribute as attached to Group 1 rather than the individual member that included the amounts in gross income would result in denying section 1341 tax benefits to any taxpayer under the facts of this case. This further supports the conclusion that the section 1341 tax attribute attaches to individual members of a consolidated group rather than to the group as a whole.

Amounts restored to Primary Claimant included amounts included in gross income both prior to the spin-off and after the spin-off but prior to the bankruptcy reorganization. The restoration to Primary Claimant occurred after the effective date of the bankruptcy plan. Consequently, the restoration of income occurred when Parent 3 constituted the common parent of the relevant consolidated group. However, from the preceding discussion it follows that if the same corporation that included the amounts in gross income is allowed a deduction attributable to the repayment of such amounts, the section 1341 tax attribute remains associated with that corporation during the period in which the restoration to Primary Claimant is made. [5]

Taxpayer has represented that Corporation 2 merged into Corporation 1 prior to the spin-off. Because Corporation 2 ceased to exist at that time, the section 1341 tax attribute that attached to Corporation 2 during the period that it recognized gross income as a partner of partnership also vanished unless section 381 or some other provision entitles Corporation 1 to succeed to that attribute. Provided that Corporation 1 assumed the refund obligation of Corporation 2 with respect to amounts Corporation 2 included in gross income pursuant to the Rate Agreements, in a transaction which qualifies under section 381(a) (1) or 381(a)(2), pursuant to section 381(c) Corporation 1 succeeds to Corporation's 2 section 1341 tax attribute for amounts included in gross income pursuant to the Rate Agreements. We do not rule on whether these requirements were satisfied.

Taxpayer has represented that various internal restructurings took place below the level of Parent 3 as part of the bankruptcy reorganization plan. The details of those restructurings have not been provided. Even so, this raises the possibility that the corporation that included the item in gross income may not be the same corporation allowed a deduction[6] for the restoration of a portion of that item of gross income to Primary Claimant. Nevertheless, provided that the corporation entitled to the deduction assumed any refund obligation to Primary Claimant relating to the Rate Agreements in a transaction that qualifies under section 381(a) (1) or 381(a)(2), the acquiring corporation succeeds to the section 1341 tax attribute of the transferor corporation pursuant to section 381(c). We do not rule on whether these requirements were satisfied.

As noted above, Treas. Reg. § 1.381(a)-1(b)(3)(i) leaves open the possibility that a corporation that acquires the assets of another corporation may succeed to a tax attribute of the corporation whose assets are acquired notwithstanding that the

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[5] Payments made by members of the consolidated group that did not include the disgorged items in their separate taxable income in a prior taxable year, other than payments made by entities that succeed to the section 1341 tax attribute of the corporation that originally included the item in gross income, are treated as made on behalf of the entity liable for the disgorgement. For example, Parent 3's issuance of stock to Primary Claimant to partially satisfy the liabilities at issue is treated as if Parent 3 sold the stock for cash and then made capital contribution of that cash in a manner designed to get the cash to the entities liable for the overcharge. The corporations owning the disregarded entities liable for the overcharges would be entitled to the deductions.

[6] The restoration of amounts previously included in gross income qualify as trade or business deductions under section 162(a) when paid. See Treas. Reg. § 1.461-4(g)(3) (in the case of a liability to pay a rebate, refund, or similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed).

acquisition satisfies neither section 381(a)(1) nor section 381(a)(2) or the tax attribute at issue is not listed in section 381(c). We express no opinion in this case as to whether the corporation that is allowed a deduction for restoring an item of gross income to Primary Claimant succeeds to the section 1341 tax attribute of the corporation that originally included the item in gross income if the requirements of neither section 381(a)(1) nor section 381(a)(2) are met.

The Inventory Rule, the Public Utility Exception, and Other Issues

Even if the requirements of section 1341(a)(1)-(3) are satisfied, the tax benefits of section 1341 are denied for deductions that fall within the inventory rule of section 1341(b)(2). That rule denies the tax benefits of section 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 his trade or business. Product A actually consists of two subproducts, Subproduct A1 and Subproduct A2, the later of which in turn consists of several different items. Although an argument can be made that certain items falling within the scope of Subproduct A2 qualify as the sale of something other than goods, it is clear that the sale of Subproduct A1 constitutes the sale of goods. Therefore, the inventory rule may deny the tax benefits of section 1341 to some of the items at issue unless an exception to that rule applies.

Such an exception applies in the case of certain refunds required to be made by regulated public utilities (the public utility exception). Section 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.

The repayments at issue were required pursuant to the terms of the Settlement Agreement as approved by the Bankruptcy Court and Regulatory Agency. Consequently, the public utility exception to the inventory rule applies if the refunds at issue arise with respect to rates made by a regulated public utility.

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 including Regulatory Agency. Prior to the Revenue Reconciliation Act of 1990's elimination of that provision to remove certain deadwood provisions from the Code, section 167(l) provided various depreciation rules for public utility property. Section 167(l)(3)(A) defined public utility property in part as property used predominantly in the trade or business of the furnishing or sale of certain items if:

> the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Treas. Reg. § 1.167(l)-1(b)(1) further provides that the term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved. For purposes of this ruling, there is no relevant difference between the “established or approved” paragraph of section 7701(a)(33) relevant to this case, and the section 167(l)(3)(A) language quoted above. Simultaneously with the repeal of section 167(l)(3), for purposes of applying certain depreciation rules Congress again defined public utility property in section 168(i)(10) using the same language previously found in section 167(l)(3)(A). Consequently, the established or approved requirement of section 7701(a)(33) does not require the regulator to determine rates in a formal rate proceeding.

Rev. Rul. 82-109, 1982-1 C.B. 7, discussed treatment of investment tax credits under provisions of the Code analogous to the ones at issue here. It held that property that is a qualifying facility under section 201 of the Public Utilities Regulatory Policy Act of 1978 is not public utility property under section 48(l)(17) of the Code (as in effect at the time of the issuance of the revenue ruling) if the rates charged are not determined on a rate-of-return basis. The primary issue in that ruling was whether or not such a facility could be energy property within the meaning of section 48(l). Section 48(l)(17) excluded public utility property from classification as energy property in certain cases.

Public utility property was defined for purposes of section 48(l)(17) by section 46(c)(3)(B) as property used predominantly in the trade or business of the furnishing or sale of electricity for which the rates are regulated by a federal or state governmental body. Section 1.46-3(g)(2)(iii) of the regulations provided that a taxpayer's rates are regulated if they are established or approved on a rate-of-return basis; that is, the rates cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investments are determined by the use of a uniform system of accounts prescribed by the regulatory body.

Regulatory Agency has exclusive regulatory jurisdiction over Tier 1 rates for the sales of Product A at issue in this case. Regulatory Agency has the responsibility to ensure that any rates charged are just and reasonable and that they are not unduly discriminatory or preferential.

Under standard procedure for setting rates a seller of Product A files a rate schedule with Regulatory Agency for the agency's approval. Regulatory Agency may accept the rates as filed subject to its authority to investigate and change the rates, terms, and conditions under the just and reasonable and not unduly discriminatory or preferential standard. Regulatory Agency may accept for filing but suspend the effectiveness of the rates pending a hearing or other investigation. Parties that would be affected by the rates may challenge them before Regulatory Agency.

In the instant case the terms of the Rate Agreements at issue came into existence through an evolving process that took into account experience acquired through the impact of terms of prior rate agreements and that involved negotiations between both buyers and sellers of Product A. However, all of the rates for Product A established by these agreements fell under the jurisdiction of Regulatory Agency and were subject to its approval. Regulatory Agency approved a partial settlement of issues resulting in the terms of the Rate Agreements at issue and also approved these Rate Agreements subject to future resolution of certain issues, including the cost share issue. Furthermore, as previously noted, on Date 7, Regulatory Agency approved the settlement of the amounts at issue.

The next question concerns whether each of the amounts at issue relate to rates determined on a rate-of-return basis. That is, were the rates intended to allow the opportunity to recover the cost of producing Product A, which in the regulated rate context includes both a return of and on investment. In contrast to the usual garden variety cost based regulated rate, in which all of the production is subject to the regulated rates, Entity A and Entity B sold Product A in both competitive bid based market transactions and also pursuant to the Rate Agreements. Entity A and Entity B relied in large part on market-based transactions as a means to recover their investment in the production facilities and to earn a return on that investment. Nevertheless, for purposes of applying the rate-of-return test, Entity A and Entity B's total investment in production facilities may be treated as split between the use of such facilities to produce Product A sold in competitive bid-based market transactions and Product A sold pursuant to the Rate Agreements.

The cost share issue concerned the appropriate percentage of certain costs that should be recoverable for the provision of Product A pursuant to the Rate Agreements. These costs included certain sunk fixed costs and other fixed costs as well as a provision allowing for a return on investment. Entity A and Entity B were allowed to take a significant percentage of these amounts into account in earning revenue from the sale of Product A pursuant to the Rate Agreements. When this formula was challenged, the Regulatory Agency administrative law judge found it to be inappropriate. The administrative law judge proposed a cost recovery technique that would have eliminated a large percentage of the costs previously recovered by Entity A and Entity B through sales of Product A pursuant to the Rate Agreements. The administrative law judge rejected the position that sales of Product A should be compensated under traditional cost-based ratemaking principles. Because the amounts in issue were collected under a rate formula rejected by the administrative law judge, it follows that the judge viewed this formula as based on cost-based ratemaking principles.

Regulatory Agency never definitively ruled on the cost share issue although it did approve the Settlement Agreement. The amount of claims paid under the Settlement Agreement constitutes a compromise of the positions taken by the parties before the administrative law judge. We conclude that Entity A and Entity B qualified as regulated public utilities within the meaning of section 7701(a)(33) with respect to income recognized from sales of Product A pursuant to the Rate Agreements. Furthermore, we conclude that the portion of the amount allocable to the cost share issue refunded to Primary Claimant pursuant to the Settlement Agreement qualifies as a refund or repayment with respect to rates within the meaning of section 1341(b)(2). Therefore, the public utility exception applies to prevent the inventory rule, to the extent it would otherwise apply, from denying the tax benefits of section 1341 to amounts refunded allocable to the cost share issue.

In addition, the $E and $J claimed for alleged overcharges pertaining to Rate Agreements applicable to Year 4 concern the propriety of certain costs claimed in computing rates for the sale of Product A for that year. Specifically, these claims assert that such costs had not received adequate approval for inclusion in the computation of rates as specified under the terms of the Rate Agreements. Therefore, the public utility exception applies to prevent the inventory rule, to the extent it would otherwise apply, from denying the tax benefits of section 1341 to amounts refunded allocable to such claims.

Neither Proof of Claim 1 nor Proof of Claim 2 provides an explanation for the theory or theories for the claims relating to the invoice disputes. To the extent the invoice disputes relate to claims that the quantity of Product A billed for exceeded the quantity of Product A actually delivered, refunded amounts allocable to such claims would not be with respect to rates charged for Product A. See e.g. *Gulf States Utilities. v. Alabama Power,* 824 F.2d 1465, 1471-72 (5th Cir. 1987) (filed rate doctrine did not give Federal Energy Regulatory Commission exclusive jurisdiction over issues relating to quantity of electric power required to be purchased). Consequently, the public utility exception would not apply to claims based on quantity disputes and to the extent such claims were allocable to the sale of goods the inventory exception of section 1341(b)(2) would apply to deny the tax benefits of section 1341.

In Situation 2 of Rev. Rul. 68-153, 1968-1 C.B. 371, a railroad company restored to others certain overcharges for railway services that it had previously included in gross income during prior taxable years. The overcharges were attributable to “mere errors” on the taxpayer’s part, such as arithmetic mistakes in calculating the amounts due. However, in the taxable years of income inclusion, all the facts available to the taxpayer would, if recognized, have enabled it to correct the errors.

In Rev. Rul. 68-153 the Service concluded that the term "appeared" as used in section 1341(a) (1) of the Code and in Treas. Reg. § 1.1341-1(a) (2) 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 a taxpayer had the semblance of an unrestricted right in the taxable year of inclusion depends upon all the facts available at the end of such year. Under section 1341(a) (2), it must be established in the subsequent year that in the year of inclusion the taxpayer did not in fact or in law have an unrestricted right to the amount in question. Applying these principles to Situation 2, the Service concluded that the tax benefits of section 1341 did not apply to the refunds because in the case of "mere errors" all the facts available to the taxpayer at the end of the year of inclusion, although not availed of by it, would have indicated that the taxpayer had no right to the refunded amounts. Therefore, to the extent any overcharges claimed under the invoice disputes are the product of “mere errors” on the part of the entities that billed for the overcharged amounts, section 1341 would not apply to amounts refunded allocable to such claimed overcharges.

In order for there to be an appearance of an unrestricted right to an item of gross income within the meaning of section 1341(a)(1) in the taxable year of inclusion, there must be a factual or legal uncertainty regarding the taxpayer’s rights to such income at the close of that year. Situation 1 of Rev. Rul. 68-153 provides an example of a factual uncertainty that results in an appearance of an unrestricted right to income. In Situation 1, during World War II United States Government shipments were billed at commercial rates by the taxpayer pursuant to “section 22" and "land-grant cutback" agreements, subject to refunds in later years when wartime security restrictions were lifted. In the year of inclusion, the facts available to the taxpayer did not enable it to ascertain that lower freight charges were applicable, either because the proper freight charge was unknown, or because classification of the goods was unknown, or for both reasons.

Billings for the amounts at issue in the instant case involved the participation of an intermediate party. To the extent invoice dispute claims involve facts that were not discoverable by Entity A or Entity B until after they included the disputed amounts in gross income, such amounts satisfied the appearance of an unrestricted right requirement of section 1341(a)(1). To the extent the invoice dispute claims are based on factual uncertainties of the type discussed in this paragraph or legal disputes concerning the rates charged, the public utility exception applies to prevent the inventory rule, to the extent it would otherwise apply, from denying the tax benefits of section 1341 to amounts refunded allocable to such claims.

The $D claim relates to allegations that certain costs necessary to provide SubProduct A2 were priced incorrectly. From the preceding discussion it follows that if the overcharges occurred because of “mere errors” on the part of the seller pertaining to facts available to but not availed of by the seller, the appearance of an unrestricted right requirement of section 1341 would not be satisfied. Otherwise, such requirements are satisfied.

Allocation of Settlement Amount

As previously noted, a portion of the amounts claimed under both Proof of Claim 1 and Proof of Claim 2 consisted of interest. To qualify for the tax benefits of section 1341 the amount deducted must constitute a restoration of an amount included in gross income in one or more prior taxable years. Because payment of interest on a claim does not constitute a restoration of an amount previously included in gross income, any portion of the settlement amount allocable to interest would not qualify for the tax benefits of section 1341.

Section 4.02(10) of Rev. Proc. 2008-3, 2008-1 C.B. 110, 118 provides that the Service will not issue a ruling that determines:

> [w]hether an amount received (in periodic payments or as a lump sum) in connection with a legal action or a settlement of a legal action is properly allocated (including an allocation of all payments to one category) to recovery of capital, compensatory damages, punitive damages, dividends, interest, back pay, etc., for Federal tax purposes.

We express no opinion regarding what amounts, if any, refunded pursuant to the Settlement Agreement consist of interest. Nor do we express any opinion regarding what portion of the amounts refunded pursuant to the Settlement Agreement are allocable to any of the individual items claimed in Proof of Claim 1 and Proof of Claim 2.

Application of Section 1341(a)(5)(B)

The next issue concerns the computation of the decrease in tax under section 1341(a)(5)(B). No consolidated return regulations allocate consolidated tax liability among members of a consolidated group for purposes of the section 1341(a)(5)(B) tax reduction computation. In the absence of such regulations, we conclude that any reduction in tax under section 1341(a)(5)(B) equals the difference between the consolidated tax liability of the group that previously included the item in gross income computed with and computed without the excluded portion of that item of income.

Ruling

Subject to the caveats listed above, Taxpayer is entitled to the tax benefits of section 1341 with respect to amounts paid to Primary Claimant pursuant to the Settlement Agreement.

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.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 50. However, when the criteria in section 11.06 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 51 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

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

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,

William A. Jackson
Chief, Branch 5
(Income Tax & Accounting)

cc: