Office of Chief Counsel
Internal Revenue Service
memorandum

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to:

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from:

(Income Tax & Accounting)

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subject: Casualty Loss and Securitized Storm Cost Recovery

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

LEGEND

Taxpayer =

Regulator =

State =

Statute =

Storm =

ServiceCo =

X years =

BondCo =

ISSUE

In connection with damage, a state agency grants a regulated utility a customer surcharge for storm cost recovery, which the taxpayer securitizes as described in Rev. Proc. 2005-62, 2005-2 C.B. 507. Is the right to the surcharge "compensation" that reduces the taxpayer's casualty loss deduction under § 165(a) of the Internal Revenue Code, or is the surcharge includible in gross income under § 61 as it is collected from customers?[1]

CONCLUSION

The right to the surcharge is not compensation for the casualty loss under § 165; instead, the surcharge is includible in gross income as future sales are made under § 61 and cannot be excluded under § 111.

FACTS

The taxpayer is an investor-owned utility regulated by Regulator.

State enacted legislation, *see* Statute, permitting utilities to recover disaster restoration costs through a financing order issued by Regulator. Under such an order, as described in Rev. Proc. 2005-62, a utility is authorized to issue bonds in the amount of specified costs approved in the financing order and to recover those costs, plus the costs of financing, through a non-bypassable surcharge based on consumption by customers.[2]

State pledged in Statute that . However, the bonds were not debts of State .

Storm caused extensive damage to assets in the taxpayer's system. The loss was not covered by third-party insurance.

[1] This memorandum does not address related issues such as the amount of the casualty loss deduction or the tax treatment of recovery costs.

[2] A "non-bypassable" charge is one that is imposed on a distribution customer even if the customer chooses to purchase from a third-party supplier.

Regulator issued a financing order under Statute authorizing ServiceCo, a subsidiary of the taxpayer, to securitize specified costs related to Storm, to be funded by a customer surcharge over X years. Following the procedure described in Rev. Proc. 2005-62, ServiceCo transferred the right to the surcharge to a wholly-owned subsidiary, BondCo, which issued bonds in the amount of the specified storm recovery costs and transferred the proceeds to the taxpayer.[3]

ServiceCo collects the surcharge, through certain intermediaries, as is sold, and uses the funds to service the storm recovery bonds. The surcharge may appear as a separate line item on customers' bills. Under a statutory true-up provision, incorporated in the financing order, the surcharge is reviewed and adjusted periodically by ServiceCo and Regulator to ensure the expected recovery of amounts sufficient to service the bonds. Prospective bondholders are advised that repayment of principal and interest may be affected by certain factors, including changes in customer consumption or the bankruptcy of ServiceCo, and that the surcharge cannot be imposed longer than X years.

LAW AND ANALYSIS

Section 165(a) allows a deduction for any sustained loss not compensated for "by insurance or otherwise."

Section 61 provides that gross income means all income from whatever source derived, except as otherwise provided.

Section 111 provides that gross income does not include income attributable to the recovery of an amount deducted in a prior tax year, to the extent that amount did not reduce tax. Reimbursement for a casualty loss is excludable from income under § 111 to the extent of the amount of the casualty loss sustained that did not result in a tax benefit. *See* Rev. Rul. 71-161, 1971-1 C.B. 76 (disaster relief payments received by casualty victims).

A casualty loss is not deductible under § 165 to the extent that a taxpayer receives compensation or reimbursement, such as insurance or a government disaster grant. Under §§ 61 and 111, the compensation payments are excluded from gross income to the extent the loss was not deductible. Rev. Rul. 71-161.

A taxpayer who self-insures, however, and is able to recover the cost of a loss through its business operations, is not treated as receiving compensation for the loss. The loss is deductible, and the business income is included in gross income.

[3] The taxpayer had

When a regulated taxpayer is authorized to recover loss restoration expenses through an amount it can charge for goods or services, the situation has a dual character.

On the one hand, the charge is to some extent structured as compensation for the loss. In the present case, as the agents point out, the financing order issued by Regulator authorized the recovery of specific storm recovery costs, and such costs are acceptable as a measure of the loss of value caused by a casualty. *See* § 1.165-7(a(2)(ii) of the Income Tax Regulations.

But the charge is also structured as compensation for goods or services. The government does not reimburse the taxpayer; the taxpayer can only recover the surcharge as part of what it collects by selling to customers. A charge for the provision of goods or services is generally includible in income under § 61, as and if the charge is collected.

This dual character requires a determination as to which characterization prevails. For tax purposes, an amount can either be excludable compensation for a loss, or includible compensation for goods and services. It cannot be both.[4]

In the present case, we conclude that the surcharge is not compensation for the taxpayer's casualty loss under § 165 and § 111; instead, it is includible in the taxpayer's gross income as it sells under § 61. This conclusion is supported by authorities under both § 165 and § 61.

In *Dunne v. Commissioner*, 29 B.T.A. 1109 (1934), *aff'd,* 75 F.2d 255 (2d Cir. 1935), the taxpayer and two others were the beneficial owners of three brokerage accounts that were opened at the recommendation of a wealthy friend who, desiring to assist them in making money on the stock market, guaranteed the accounts. The court held that the taxpayer's subsequent losses were not deductible under the predecessor to § 165 because of the guarantee.

In *Shanahan v. Commissioner*, 63 T.C. 21 (1974), which involved federal disaster relief payments, the Tax Court determined that the general term "or otherwise" in § 165 must be construed consistently with the specific term "insurance." The court stated that the general purpose of insurance is to spread the risk of loss from any peril among a large number of those who are exposed to a similar peril. The court held that the disaster relief payments were compensation for the taxpayers' casualty loss.

In *Estate of Bryan v. Commissioner*, 74 T.C. 725 (1980), the court, citing *Shanahan*, determined that the phrase "insurance or otherwise" in an analogous provision, § 2054,

[4] The agents in the present case argue that the determination of deductibility must be made under § 165, and that the treatment of the proceeds under §§ 61 and 111 simply follows from that determination. We do not view the analysis as depending on which provision is considered first, or whether one provision "trumps" another. Rather, a determination as to the character of the transaction is made, which is then reflected in consistent results under the applicable provisions.

contemplates that the type of compensation received must be such that it was "structured to replace what was lost." *Id.* at 727. The court held that a disbursement from a trust fund established by a state bar association, in compensation for losses incurred due to an attorney's unethical behavior, was in the nature of insurance.

In *Boston Elevated Rwy v. Commissioner*, 16 T.C. 1084, 1111-1112 (1951), *aff'd on another issue*, 196 F.2d 923 (1st Cir. 1952), interpreting the phrase "insurance or otherwise," the Service argued that loss resulting from the abandonment of an elevated railway structure was compensated for by legislation providing for state payments guaranteeing the taxpayer operating profits sufficient to pay dividends. The court held that the state payments were not compensation for the loss, stating that "the statute undertook to assure petitioner a given level of income, after providing for various charges (including losses) representing the cost of operation … ." *Id.* at 1112.

Rev. Rul. 87-117, 1987-2 C.B. 61, considers a regulated public utility that abandoned a partially-completed nuclear plant. The ratemaking authority, in determining to grant the utility a subsequent rate increase, permitted the utility to amortize the cost of the plant over a specified number of years and include that amortization in its cost of service for ratemaking purposes. Holding that the rate increase does not reduce the utility's loss deduction on abandoning the plant, the ruling reasons that although the utility commission may give consideration to the fact that a utility suffered a loss in determining whether a rate increase is warranted, the rate is not structured to reimburse the utility for its loss. Rather the rate increase is structured to enable the utility to perform its functions of serving its customers at a fair charge, while at the same time maintaining its financial integrity and its ability to attract capital at reasonable terms by paying its investors a reasonable rate of return on their investment. The ruling notes that the increased revenue is taxable income to the utility.

Rev. Rul. 87-117 also draws an analogy to an unregulated taxpayer:

> If Taxpayer were not a regulated company, it could raise its price at will, and revenues produced by its price increase could not be considered as compensation for a loss by "insurance or otherwise." The governmental grant of authority to increase rates is of the same nature as a price increase by an unregulated company. The function of the utility commission is merely to assure that the increase is warranted.

The agents in the present case argue that *Boston Elevated* and Rev. Rul. 87-117 are distinguishable, because the financing order issued by the State Regulator in this case authorized the recovery of specific storm recovery costs, with interest, outside the normal ratemaking process. They cite to

that the taxpayer would be able to recover its storm-related costs. In addition, they note, ServiceCo transferred the right to the surcharge to BondCo, in return for cash. Finally, while the bonds issued by BondCo were not backed by the full faith and credit of the government, State did pledge

, and Regulator was

authorized to review and adjust the surcharge to help ensure timely payment of the bond liability.

The agents also criticize the analogy, drawn in Rev. Rul. 87-117, between regulated and unregulated taxpayers. They argue that an unregulated company cannot, in fact, "raise its price at will" to cover increased costs; rather, its prices are set by market competition, and there is a significant risk that it will not recover increased costs. Arguably, therefore, the regulated taxpayer who qualifies for a surcharge of this type is receiving a benefit the unregulated taxpayer does not enjoy, and this benefit should be recognized, for tax purposes, by treating the surcharge as compensation for the loss.

On balance, however, we conclude that this situation is not sufficiently distinguishable from the situation considered in Rev. Rul. 87-117 to call for a different result. Presumably, if the taxpayer's storm recovery costs had been considered by Regulator in the normal ratemaking process, under Rev. Rul. 87-117 this would not have been viewed as compensation for the loss. The securitization provides the taxpayer access to funds sooner than it might otherwise have under the normal ratemaking process, avoiding so-called "regulatory lag," and without incurring the costs of traditional third-party financing. However, the fact that a taxpayer borrows funds to recover from a loss does not mean that the proceeds of the borrowing are compensation for the loss, so long as the taxpayer remains liable to repay the loan. As in Rev. Rul. 87-117, the surcharge is not a payment from the state; it is a charge customers will pay in order to receive , and repayment of the bond liability is dependent on the taxpayer's making sufficient future sales to customers over the next X years. In this respect, the situation is unlike insurance, grants, and similar compensation: it is not necessary to provide goods or services in order to obtain insurance proceeds or a disaster grant.

With respect to the analogy between regulated and unregulated taxpayers drawn in Rev. Rul. 87-117, we recognize that the proposition that an unregulated taxpayer can or does raise prices to cover increased costs is debatable, as an economic matter. An unregulated company generally charges what the market will bear. However, the basic underlying analogy holds true. A company is regulated precisely because it has monopoly or quasi-monopoly power, and a policy decision has been made *not* to allow it to charge what the market will bear, but instead to permit it to recover, at most, certain costs plus a specified rate of return. It is quite possible that, in the absence of regulation, this taxpayer would have been able to charge, or would already be charging, a rate that would more than recoup the storm-recovery costs (and that would not be treated, for tax purposes, as compensation for its loss). It is also possible that, as disclosed to prospective bondholders, consumption patterns may change such that the taxpayer will not make sufficient sales in X years to pay off the bonds. The underlying point is that regulated taxpayers are taxed based on the general assumption that the rates set by the regulators – what customers must pay to receive goods or services –

are equivalent to market rates for an unregulated taxpayer, and are includible, as such, in gross income from business operations.[5]

The conclusion that the surcharge is includible in income when it is collected, not excludable under § 111, is also supported by authority under § 61.

In Rev. Proc. 2005-52, 2005-2 C.B. 507, the Service established safe-harbor treatment for securitizations of the type considered here.[6] Generally, the revenue procedure applies when a public utility obtains a financing order pursuant to state legislation that –

> (1) Facilitates the recovery of certain specified costs incurred by a public utility company;
>
> (2) Authorizes the public utility commission to issue a financing order determining the amount of specified costs;
>
> (3) Provides that the utility acquires an intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable;
>
> (4) Guarantees that neither the State nor any of its agencies has the authority to reduce or impair the value of the intangible property right;
>
> (5) Provides procedures assuring that the sale, assignment, or other transfer of the intangible property right from the utility to a financing entity that is wholly owned, directly or indirectly, by the utility will be perfected under State law as an absolute transfer of the utility's right, title, and interest in the property; and
>
> (6) Authorizes the securitization of the intangible property right to recover the specified costs through the issuance of bonds, notes, other evidences of indebtedness, or certificates of participation or beneficial interest that are issued pursuant to an indenture, contract, or other agreement of a utility or a financing entity that is wholly owned, directly or indirectly, by the utility.

If the requirements of the safe harbor are satisfied, the following tax treatment applies under § 6 of the revenue procedure:

> .01 The utility will be treated as not recognizing gross income upon –

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[5] The agents also argue that Rev. Rul. 87-117 is distinguishable from the present case because the decision to abandon the plant in Rev. Rul. 87-117 was a voluntary decision and therefore not an "insurable event," unlike the present case. The rationale of the revenue ruling does not depend on this distinction, however, and neither the regulations nor the case law draw a distinction based on whether a loss was a casualty or noncasualty loss, whether the risk of loss was insurable, or the degree to which the loss was "voluntary." *See* Reg. § 1.165-1(a); *Dunne* (no deduction for stock losses where a friend agreed to indemnify taxpayer).

[6] The revenue procedure superseded Rev. Proc. 2002-49, 2002-2 C.B. 172, which was restricted to securitization of stranded costs resulting from the deregulation of electric generation operations.

> (1) The receipt of a financing order that creates an intangible property right in the amount of the specified costs that may be recovered through securitization;
>
> (2) The receipt of cash or other valuable consideration in exchange for the transfer of that property right to a financing entity that is wholly owned, directly or indirectly, by the utility; or
>
> (3) The receipt of cash or other valuable consideration in exchange for securitized instruments issued by the financing entity that is wholly owned, directly or indirectly, by the utility.
>
> .02 The securitized instruments described in Section 5.04 will be treated as obligations of the utility.
>
> .03 The non-bypassable charges are gross income to the utility recognized under the utility's usual method of accounting.

The agents agree that the taxpayer's securitization met the requirements of Rev. Proc. 2005-52. But they point out that while § 6.01 of the revenue procedure provides that a qualifying securitization does not result in the recognition of gross income at the time it occurs, the revenue procedure does not, by its terms, prohibit treating the securitization as reimbursement that reduces a deduction.

Under § 6.02 and .03 of Rev. Proc. 2005-52, however, the bonds issued by BondCo are treated as obligations of ServiceCo, and the surcharges are gross income to ServiceCo when they accrue. As discussed above, both these determinations are incompatible with a finding that the right to the surcharge was compensation that reduced the taxpayer's casualty losses: Borrowed funds are not compensation for a loss, and inclusion of the surcharge in gross income as it is collected is inconsistent with treating it as reimbursement for a past loss, excludible from income under § 111.

More generally, the revenue procedure can be read as an indication that in these particular circumstances,[7] the Service has chosen to characterize the surcharge as income from future operations, not as a current benefit to be taken into account in the year the securitization occurs. If so, then treatment of the right to the surcharge, or the proceeds of the bond issuance, as a reduction in an otherwise allowable deduction is inconsistent with the intent of the safe harbor.

Accordingly, we conclude that under § 165, the taxpayer's casualty loss deductions are not reduced by the proceeds of the bond issuance. Under § 61, the taxpayer must include the surcharge amounts as income from future sales, and cannot treat them as an excludible recovery under § 111.

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[7] Rev. Proc. 2005-62 notes that these securitization statutes are unique to regulated utilities, and the tax treatment allowed by the revenue procedure is peculiar to these situations.

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Please call (202) 622-5020 if you have any further questions.

By: _____

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