

when the FERC approved its regulations requiring pipeline supplier rate charges to be on an "as billed" basis it "was not unaware of the importance of trying to match the benefits and the costs."

Editor's Note: At its September 26, 1985 meeting, the Commission indicated that it plans to break with the "idea of cash flow accounting" in regards to unpaid accruals. The Commission may use this docket as its vehicle.

RECENT UTILITY TAX DEVELOPMENTS

SAFE HARBOR LEASE PROCEEDS MUST BE NORMALIZED

A number of regulated public utilities transferred their tax benefits to third parties under safe harbor leases in 1981 and 1982. A recent ruling by Internal Revenue Service indicates that these utilities should review the rate treatment provided for the transactions to assure that it conforms to tax normalization requirements.

IRS has recently issued a private letter ruling (LTR 8537063) which holds that the rate treatment provided for the proceeds from a sale of tax benefits in a safe harbor lease of public utility property must satisfy the federal tax law normalization requirements for the Accelerated Cost Recovery System (ACRS) and investment tax credit (ITC). Generally, this means that the transfer of tax benefits was effective only if cash sale proceeds were accounted for in a way that was appropriate for the underlying tax benefits transferred, ACRS depreciation and ITC.

Background

When the safe harbor lease legislation was enacted to be effective in 1981, there was no mention of normalization. The Technical Amendments Act of 1982 clarified Congressional intent for normalization by adding the requirement that rate treatment must be consistent with that required for ACRS and ITC tax benefits. This amendment was retroactive to 1981. Regulations have not yet been issued on this subject but statutory language seems quite clear that the cash sale proceeds received by the seller-lessor for the transfer of tax benefits must be accounted for and receive rate treatment that is consistent with the normalization rules provided for ACRS and ITC. Since sale proceeds from a safe harbor lease were the means by which the original acquirer of eligible property realized the tax benefits of ACRS and ITC, the capital formation purposes for which Congress enacted these provisions dictate that these sale proceeds be subject to the tax normalization rules.

Only "recovery" property was eligible for safe harbor leasing. Recovery property is tangible, depreciable property placed into service after 1980. A special rule required normalization for public utility

property to be classified as recovery property. In addition, for an effective transfer of public utility property tax benefits, normalization of both depreciation and ITC tax benefits was a prerequisite for a transaction to qualify as a safe harbor lease. Therefore, failure to normalize either ACRS or ITC tax benefits would cause the disqualification of a safe harbor lease.

IRS Ruling

The utility, an option two company [SEC. 46(f)(2)], proposed to defer the sale proceeds and amortize them to cost of service over the service life of the property, without reducing rate base by the balance in the deferred credit account. The Commission proposed that the deferred proceeds of the sale be deducted from rate base and also that the depreciable basis of the property be reduced by the net proceeds, following the rationale that capital was provided from a source other than investors. The Commission order was suspended subject to a definitive ruling from IRS.

The Service ruled that if the Commission's order became final and rate base was reduced by the deferred sale proceeds, SEC. 46(f)(2), which precludes rate base reductions for ITC, would be violated. Since a safe harbor lease must receive rate treatment consistent with the ITC normalization requirement of section 46(f), the transaction would not qualify as a safe harbor lease.

Observations

Although this private letter ruling deals with a proscribed rate base reduction, the clear implication is that IRS ruling policy is to treat any normalization violation as disqualifying a safe harbor lease.

The ruling is silent on the Commission's proposal to reduce the depreciable basis of the safe harbor property by the sale proceeds. This would cause a reduction in depreciation expense. The resulting reduction in cost of service, if in addition to the reduction resulting from ratable amortization, would also appear to be a violation of ITC normalization because it would be an accounting for the credit that caused more than a ratable reduction in cost of service.

The ruling leaves other points unexplored. It doesn't discuss the impact that the suspended Commission order would have on the normalization of the portion of sale proceeds attributable to ACRS depreciation. Unfortunately, neither does it discuss the allocation of sale proceeds to the underlying transferred tax benefits of accelerated depreciation and ITC. How much ITC and depreciation are included in sale proceeds?

Apparently, the Service found the rate base reduction sufficient violation of normalization to disqualify the safe harbor lease and chose not to deal with other intricacies of the transaction.

The safe harbor lease provisions were repealed, subject to certain transitional rules, by the 1984 Act. Further, public utility property was specifically excluded, by TEFRA, from the "modified" safe harbor leasing provisions as of July 1, 1982. However, indemnification clauses contained in most safe harbor leases will cause serious repercussions to sellers of public utility property tax benefits where improper rate treatment was required at the insistence of a regulatory authority.

IRS has held in two private letter rulings, both involving quite unique facts, that an "inadvertent" violation of the ITC normalization rules that was corrected by the Commission upon discovery did not result in the disallowance of tax benefits.

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