

**FEDERAL TAX PROVISIONS AFFECTING
THE ELECTRIC POWER INDUSTRY**

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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present-law Federal tax provisions relating to the electric power industry. The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on this subject on June 13, 2001.

This document describes the principal current Federal tax provisions specifically relating to the electric power industry, including provisions related to investor-owned, publicly-owned, and cooperatively-owned utilities, for non-utility generators, and other participants in the electric power industry.

Part I of the document is a summary. Part II is a description of present-law Federal tax provisions affecting electric service providers.

¹ This document may be cited as follows: Joint Committee on Taxation, *Federal Tax Provisions Affecting the Electric Power Industry* (JCX-54-01), June 11, 2001.

I. SUMMARY

In 1999, production and use of electricity comprised 35.8 percent of total energy consumption in the United States,² and in 1999 sales of electricity comprised 2.3 percent of gross domestic product. In residential and commercial non-transportation uses, electricity comprised 69.4 percent of total energy use, while electricity accounted for 31.9 percent of the energy used by industry.³ The residential sector is the largest end-user of electricity, having consumed 34.6 percent of all electricity consumed in 1999. The industrial sector consumed 32.0 percent of electricity, while commercial users consumed 30.3 percent.⁴

The electric power industry generally is comprised of three types of electric utilities-- investor-owned utilities ("IOUs"), publicly owned utilities ("public power"), and electric cooperatives ("co-ops")--and of certain non-utility ("independent power") producers. Independent power producers sell most of their electricity to electric utilities that resell the power to final consumers. In 1999, IOUs provided 74.1 percent of final electricity sales, public power 15.4 percent, and co-ops 8.9 percent.⁵

The provision of electricity involves four distinct functions: generation, transmission, distribution, and retail sales. "Generation" involves the creation of electricity. The "transmission" of electricity refers to the transportation of electricity from generation sites to distribution centers. The "distribution" of electricity refers to the transportation of electricity from distribution centers to customers' homes and businesses. The "retailing" function involves metering and billing final customers. Retailing also may require the retailer to contract with generators and owners of transmission and distribution systems for the provision of electricity. Historically, most electricity was provided by vertically integrated suppliers that performed each of the four functions of generation, transmission, distribution, and retailing.

² Energy Information Administration, U.S. Department of Energy, *Annual Energy Review 1999* (July 2000). The Department of Energy estimates that in 1999 the United States consumed 96.60 quadrillion British thermal units ("Btu") of energy from all sources and that direct consumption of electricity and electrical system energy losses accounted for 34.56 quadrillion Btu.

³ Energy Information Administration, U.S. Department of Energy, *Monthly Energy Review* (February 2001). Electricity comprised 0.2 percent of energy used in transportation.

⁴ *Id.* at 101.

⁵ Energy Information Administration, U.S. Department of Energy, *Electric Sales and Revenue 1999* (October 2000). These figures are based on millions of kilowatt hours, rather than dollars of sales. In 1999, over 3.2 trillion kilowatt hours of electricity were sold by the U.S. utilities. Of that total, roughly 2.4 trillion kilowatt hours were sold by IOUs, 499 billion kilowatt hours by public power utilities, 288 billion kilowatt hours by co-ops, and 52 billion kilowatt hours by direct sales from Federal power authorities to final consumers.

This pamphlet describes present-law Federal tax provisions applicable to the electric power industry.

A. Tax Provisions Primarily Affecting Municipal Electric Service Providers: Tax-Exempt Financing

Interest on debt incurred by States or local governments is excluded from the income of the lender ("bondholder") if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds of those entities. Interest on bonds that nominally are issued by States or local governments, the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds"), is taxable unless the purpose of the borrowing is approved specifically in the Internal Revenue Code (the "Code") or in another provision of a revenue Act. The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments.

The provision of electric service (generation, transmission, distribution, and retailing) is a governmental activity eligible for financing with governmental tax-exempt bonds when the financed facilities are used by or paid for by a State or local government entity (e.g., by public power). As with other governmental activities, public power also is eligible for limited tax-exempt financing of working capital costs (e.g., salaries of employees and similar expenses). Except as described in Part II, private IOU and co-op electric service providers generally are not eligible for tax-exempt financing of their facilities.

B. Tax Provisions Primarily Affecting Investor-Owned Utilities

Cost recovery of property used in the production, transmission, and distribution of electricity

A taxpayer generally must capitalize the cost of property used in a trade or business and is allowed to recover the cost over time through allowances for depreciation and amortization. Cost recovery rules for ratemaking and Federal income tax purposes are important to electric utilities because of the capital-intensive nature of the industry. The methods used by IOUs generally recover the cost of public utility property more rapidly for Federal income tax purposes than do the methods used for ratemaking or financial accounting purposes.

In order for public utility property to be eligible for the more favorable depreciation allowances available for Federal income tax purposes (relative to the depreciation allowances used for ratemaking or financial statement purposes), the tax benefits of accelerated depreciation must be "normalized" in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. The normalization method of accounting generally spreads the tax benefits of accelerated depreciation over the regulatory life of the property and results in higher utility rates in the early years and lower utility rates in the later years than otherwise would have occurred.

Other tax provisions

A number of additional provisions affect IOUs, either because they provide rules specifically applicable to utilities, or because they govern the Federal income tax treatment of transactions in which IOUs are likely to engage.⁶ Some provisions, such as the provision allowing for the deduction of certain deposits to nuclear decommissioning funds, assume a regulatory framework.

Deferred tax accounts: financial, regulatory, and tax accounting issues

Generally Accepted Accounting Principles require a deferred tax account whenever temporary differences exist between the Federal income tax accounting and financial accounting treatment of an item. When the difference will result in amounts taxable in the future, a deferred tax liability is created. When the difference will result in amounts deductible in the future, as well as when there is an anticipated reduction in future tax liability attributable to the carryforward of items such as net operating losses and tax credits, a deferred tax asset is created.

General corporate restructuring tax issues

The disposition or combination of businesses and assets can be structured in various ways, producing various tax results. Assets or businesses may be disposed of for cash or otherwise in taxable transactions. If certain continued stock ownership requirements are met, transactions also may be structured in a form that is not immediately taxable. Partnerships also may be utilized to combine corporate activities or to readjust the future interests of contributing partners in those activities. There may be limitations on the future use of existing losses at the corporate level if more than 50 percent of the corporate stock changes hands. Also, certain acquisitions that are part of a plan or series of related transactions may result in corporate level tax in connection with certain corporate "spin-off" transactions, in which a corporate business is distributed to shareholders as a separate corporation.

Generally, the various corporate reorganization provisions of present law apply to IOUs in the same manner as other entities.

C. Tax Provisions Affecting Electric Cooperatives

Under present law, a rural electric cooperative is exempt from Federal income tax if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to the members.

⁶ Except for possible activities not exempt from tax under section 115, tax provisions other than those governing tax-exempt financing generally do not affect public power entities, because under section 115, public power is exempt from all Federal income tax as a State or local government entity.

D. Special Energy Tax Incentive Provisions

Tax credit for electricity produced by wind, closed-loop biomass, and poultry waste facilities

An income tax credit is allowed for the production of electricity from either qualified wind energy facilities, qualified "closed-loop" biomass facilities, or qualified poultry waste facilities. The credit is allowed for production during the 10-year period after the facility is placed in service. The credit amount is indexed for inflation. In 2001, the credit is equal to 1.7 cents per kilowatt hour of electricity produced. Qualified facilities are facilities placed in service prior to January 1, 2002.

Tax credit for qualified solar and geothermal energy property

The credit for solar and geothermal energy property is a nonrefundable business energy tax credit equal to 10 percent of the cost of qualified solar and geothermal energy property. This credit is permanent.

II. FEDERAL TAX PROVISIONS AFFECTING ELECTRIC SERVICE PROVIDERS

A. Tax Provisions Primarily Affecting Municipal Electric Service Providers: Tax-Exempt Financing

In general

Interest on debt⁷ incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103).⁸ Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable, unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments.⁹

The general structure of the rules for determining whether a tax-exempt bond is a governmental or a private activity bond was established in 1968. The Tax Reform Act of 1986 (the "1986 Act") further restricted the amount of private use that may be financed before a State or local government bond is classified as a private activity bond, and enacted extensive additional restrictions on tax-exempt financing generally.

The provision of electric service (generation, transmission, distribution, and retailing) is an activity eligible for financing with governmental tax-exempt bonds when the financed

⁷ Hereinafter referred to as "State or local government bonds," even though not all tax-exempt debt results in the issuance of a formal bond (e.g., installment sales agreements are treated as bonds).

⁸ Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.

⁹ Interest on Federal debt is taxable. However, unlike most State or local government debt, Federal debt benefits from the Federal Government's guarantee of repayment. The Code includes limited exceptions allowing the combination of these benefits, generally for programs that were in existence before enactment of the Tax Reform Act of 1984.

One such exception allows certain tax-exempt financing of State or local government facilities that transmit and distribute electric power supplied by the Bonneville Power Administration (the "BPA"), a Federal instrumentality. In addition, section 1316(d) of the Tax Reform Act of 1986 codified a prior-law Treasury Department regulation that treated the BPA as a State or local government unit rather than as a Federal entity. These exceptions are unique to the BPA; other Federal power agencies are treated as Federal entities and are not permitted to benefit from tax-exempt financing or to guarantee such financing.

facilities are used by or paid for by a State or local governmental entity (e.g., "public power").¹⁰ As with other governmental activities, public power entities also are eligible for limited tax-exempt financing of working capital costs (e.g., salaries of employees and similar expenses). Except as described below, IOUs and co-ops generally are not eligible for tax-exempt financing of their facilities. With the exception of certain charitable organizations that are described in Code section 501(c)(3), private businesses are not eligible to finance working capital costs with tax-exempt bonds (except with proceeds of a permitted five-percent "bad money" portion of a bond issue which may be used for any type of expenditure).

Classification of bonds as private activity bonds

Present law provides two tests for determining whether a State or local government bond is, in substance, a private activity bond (sec. 141(b) and (c)).

Private business test.--Private business use and private payments result in State or local government bonds being private activity bonds if both parts of a two-part private business test are violated--

- (1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and
- (2) More than 10 percent of the debt service on the bonds directly or indirectly is secured by an interest in property to be used for a private business use or is to be derived from payments in respect of such property (the "private payment test").

The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. For example, a privately operated cafeteria in a government office building financed as part of the building's construction could represent a related private business use. On the other hand, a separate, private manufacturing facility financed with proceeds of the same bond issue would constitute an unrelated private business use of bond proceeds. Additionally, as described more fully below, since enactment of the 1986 Act, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

Private business use generally includes any use by a business entity (including the Federal Government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury Department regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Similarly, in the case of public power entities, if output of an electric generating plant or

¹⁰ Section 115 also exempts the income that States and local governments derive from the operation of public power systems as governmental activities.

transmission or distribution facilities is provided to a private business on terms not generally available to other customers of the entity, an allocable portion of bonds financing the facilities is treated as used in a private business use and as secured by the payments from the private business.¹¹

Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury Department regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.¹² These rules require public power entities to restrict the period of contracts with private businesses as well as the aggregate amount of electric service provided to private businesses on terms that are not generally available to customers of the entity, if interest on their bonds is to remain tax-exempt.

Private loan test.--The second standard for determining whether a State or local government bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) \$5 million is used directly or indirectly to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

Present law provides that the substance, rather than the form, of a transaction governs in determining whether a transaction gives rise to a private loan. In general, any transaction, which transfers tax ownership of property to a private person, is treated as a loan. In the context of electric facilities, longer-term contracts for the sale of electricity may violate the private loan test, because these contracts have the substantive characteristics of a loan.

¹¹ See, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987, stating as follows:

The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property [B]ond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government salaries, or to pay legal judgments against a governmental unit, are not treated as used in the business of the payee. This is to be contrasted with the indirect nongovernmental private use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's trade or business with a service (e.g., electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (e.g., a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public. (p. 1160)

¹² See Treas. Reg. sec. 1.141-3(b)(4) and Revenue Procedure 97-13, 1997-1 C.B. 632.

Special legislative rules for tax-exempt financing of governmental "output" facilities

In addition to the general private business use and payment tests, the Code includes three specific provisions governing the issuance of governmental tax-exempt bonds to finance electric service facilities.

\$15 million limit on private business use.--As stated above, the 1986 Act provided an additional restriction on private business use of State or local government bonds whose proceeds are to be used to finance "output" facilities.¹³ Output facilities include, inter alia, facilities for electric and gas generation, transmission, and distribution. A bond is treated as issued to finance an output facility (and subject to this restriction) if five percent or more of the proceeds is to be used with respect to any output facility. Under this restriction, the 10-percent private business use and private payment tests in substance are phased down for facilities that receive more than \$15 million in tax-exempt bond financing. Significantly, unlike most tax-exempt bond restrictions, which are determined on a bond-issue by bond-issue basis, this restriction is measured by reference to all outstanding tax-exempt financing from which a facility benefits.

Special rules disregarding certain private business use under the private activity bond tests.--The legislative history accompanying the 1986 Act further clarified that certain sales of electric power by public power entities to private businesses generally are disregarded in applying the private business and private loan tests. For example, the presence of a nongovernmental person acting solely as a conduit for exchange of electric output among governmentally owned and operated public power entities are to be disregarded. In addition, exchange agreements that provide for "swapping" of electricity between governmentally owned and operated entities and IOUs do not give rise to private business use when (1) the "swapped" amounts are approximately equal over a period of one year or less, (2) the electricity is swapped pursuant to an arrangement which does not involve output-type contracts, and (3) the purpose of the arrangements is to enable the parties to satisfy differing peak load demands or to accommodate temporary outages.¹⁴ Finally, the legislative history of the 1986 Act provides that "spot sales" of excess power capacity for temporary periods not exceeding 30 days do not violate the private business tests.

Bonds for acquisition of existing output property *per se* private activity.--In general, any bond with respect to which five percent or more (\$5 million if less) of the proceeds is to be used, directly or indirectly, by a governmental entity to acquire existing output property is *per se* a private activity bond.¹⁵ As such, interest on the bond is taxable, unless the use of the acquired

¹³ Sec. 141(b)(4).

¹⁴ See, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987 at 1164.

¹⁵ Sec. 141(d). A permanent exception allows the Long Island Power Authority to issue governmental tax-exempt bonds for the acquisition of the Long Island Lighting Company ("LILCO") and conversion of that electric utility from a private investor-owned utility to a public power entity. Pub. L. No. 100-203, sec. 10631(c)(3) (1987).

facility satisfies the provisions applicable to tax-exempt private activity bonds for the local furnishing of electricity, including receipt of an allocation of the applicable State's annual private activity bond volume authority (described below). The two-county (or a city and a contiguous county) service area requirement that applies to facilities for the local furnishing of electricity does not apply in this circumstance.

There are two exceptions to the rule regarding the acquisition of existing output property. First, the rule does not apply to bonds for the acquisition of existing facilities that will provide service in a "qualified service area" of the issuer. A qualified service area is defined as an area throughout which the acquiring entity has provided electric service for at least the 10-year period preceding the date of the acquisition. Second, the rule does not apply to bonds issued to acquire existing output property to be used in a "qualified annexed area" of a public power entity. The term qualified annexed area includes only areas (1) that are contiguous to existing service areas, (2) that are annexed for general governmental purposes, and (3) the size of which does not exceed 10 percent of the public power entity's service area before the annexation occurs.

Temporary Treasury regulations

On January 18, 2001, the Treasury Department issued temporary and proposed regulations to provide guidance to issuers of governmental bonds for output facilities ("the regulations"). The regulations provide special rules for determining whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. The regulations replace temporary and proposed regulations issued in January of 1998. The regulations generally apply to bonds sold on or after January 19, 2001, and are scheduled for a public hearing before the IRS on July 24, 2001. The regulations generally allow public power entities to participate in certain electric industry restructuring arrangements without endangering tax-exemption for interest on their bonds.

General rule

The regulations provide that purchase by a private person of available output of an output facility financed with the proceeds of an issue is taken into account under the private business tests if the purchase has the effect of (1) transferring substantial benefits of owning the facility and (2) transferring substantial burdens of paying the debt service on bonds used to finance the facility (the benefits and burdens test).¹⁶ An arrangement transfers substantial benefits if it provides the purchaser with rights to bond-financed property that are preferential to the rights of the general public. An arrangement transfers substantial burdens of paying debt service to the extent the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances).

Requirements contracts.--The regulations provide that requirements contracts give rise to private use provided the benefits and burden tests are met.¹⁷ Significant factors that tend to

¹⁶ Temp. Treas. Reg. sec. 1.141-7T(c)(1) and (c)(2).

¹⁷ Temp. Treas. Reg. sec. 1.141-7T(c)(4).

establish that a wholesale requirements contract results in private business use include, but are not limited to: (1) the purchaser's customer base has significant indicators of stability, (2) the contract covers historical requirements of the purchaser, and (3) the purchaser agrees not to construct or acquire other power resources to meet the requirements covered by the contract.

Payments pursuant to pledged contract.--Payments made or to be made under the terms of an output contract that is pledged as security for an issue are taken into account under the private business tests even if the issuer reasonably expects that it is not substantially certain that payments will be made under the contract (disregarding default, insolvency, or other similar circumstances).

Measuring available output

Generation facilities.--Under the regulations, the private business use of a generating facility is generally measured based on the amount of "output purchased" by the private user divided by the available output of the facility. Available output is generally defined as the annual nameplate capacity of the generating facility multiplied by the number of years in the underlying bond's measurement period.¹⁸ Generally, the regulations provide that nameplate capacity is not reduced for reserves, maintenance or unutilized capacity.¹⁹

Transmission facilities.--For transmission facilities, the regulations provide that the available output of transmission facilities may be determined in a manner consistent with reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission.²⁰

Certain contracts not taken into account under the private business tests

Small purchases of output.--The regulations provide that an output contract is not taken into account under the private business tests if the average annual payments under a contract that are substantially certain to be made by a private user do not exceed .05 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility determined as of the date of the contract.²¹

Short term contracts.--Under the regulations, an output contract with a private user is not taken into account under the private business tests if: (1) the term of the contract (including renewal options) is not longer than one year; (2) the contract is an arm's length agreement that provides for compensation at fair market value, or is based on generally applicable and

¹⁸ Temp. Treas. Reg. sec. 1.141-7T(b)(1) and (b)(1)(i).

¹⁹ *Id.*

²⁰ Temp. Treas. Reg. sec. 1.141-7T(f)(4).

²¹ Temp. Treas. Reg. sec. 1.141-7T(f)(1).

uniformly applied rates; and (3) the output facility was not financed for a principal purpose of providing that facility for use by a private person.²²

Excess generating capacity resulting from participation in open access.--The regulations contain an exception to the private use test for the sale of excess generating capacity due to participation in open access.²³ Under the regulations, output sales attributable to excess generating capacity from participation in open access are not treated as private use if the following requirements are satisfied: (1) the term of the contract is not longer than three years (including renewal options); (2) the issuer does not make expenditures to increase the generating capacity of its system with tax-exempt bonds by more than three percent during the term of the contract; (3) the issuer offers open access transmission tariffs under rules promulgated by the Federal Energy Regulatory Commission under sections 205 and 206 of the Federal Power Act (or comparable provisions of State law); (4) all of the output sold under the contract is attributable to excess capacity resulting from open access transmission tariffs; and (5) all payments received by the issuer (less operating expenses) are promptly applied to redeem tax-exempt bonds that financed the facility.

Special exceptions for transmission facilities

The regulations include two exceptions under which mandated wheeling, and actions taken to implement nondiscriminatory open access, will not be treated as deliberate actions resulting in private business use. The first exception is for contracts entered into in response to (or in anticipation of) an order under sections 211 or 212 of the Federal Power Act (or comparable State laws). The terms of the contract must be bona fide and arm's length and the consideration paid must be consistent with the provisions of section 212(a) of the Federal Power Act. The second exception for other actions taken by public power entities to implement the offering of non-discriminatory, open-access tariffs for the use of transmission facilities financed by an issue in a manner consistent with rules promulgated by the Federal Energy Regulatory Commission under sections 205 and 206 of the Federal Power Act (or comparable provisions of State law). The second exception, however, does not apply to the sale exchange or other disposition of transmission facilities to a private person.²⁴

Issuance of tax-exempt bonds for private activities

As stated above, interest on State or local government bonds to finance activities of private persons (both business and personal activities) is taxable unless a specific exception is contained in the Code (or in non-Code provision of a revenue Act). The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued

²² Temp. Treas. Reg. sec. 1.141-7T(f)(3).

²³ Temp. Treas. Reg. sec. 1.141-7T(f)(4).

²⁴ Temp. Treas. Reg. sec. 1.141-7T(f)(5)(ii).

by issuers within each State. The Code further imposes several additional restrictions on tax-exempt private activity bonds that do not apply to bonds for governmental activities.

Eligible activities

In general.--States or local governments may issue tax-exempt exempt-facility bonds to finance facilities for certain private businesses.²⁵ Business uses eligible for this financing generally include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and, certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." This provision was enacted to permit tax-exempt financing of certain renovations to the dams and accompanying hydroelectric electric generating facilities along the Columbia River that are a part of the Bonneville Power Administration system.²⁶

Tax-exempt financing is authorized for capital expenditures for certain manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), certain local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Further, certain non-business private purposes may be financed with proceeds of these bonds: certain student loans, mortgage loans for first-time home buyers satisfying moderate income and home purchase price requirements, and mortgage loans generally for certain pre-1977 veterans who purchase homes in any of the five States that historically authorized issuance of these bonds.²⁷ Finally, both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt bonds ("qualified 501(c)(3) bonds").

Private activity bonds for the local furnishing of electricity.--Tax-exempt private activity bonds may be issued by States or local governments acting as conduits to finance generation,

²⁵ A separate non-Code exception allows the State of Iowa to issue tax-exempt private activity bonds to finance an industrial new jobs program.

²⁶ Two additional non-Code provisions allow tax-exempt financing for certain electric generating facilities located in the State of Alaska. The first of these treats the Bradley Lake hydro-electric generating plant as a facility for the local furnishing of electricity. The second authorized issue of tax-exempt private activity bonds to finance the sale by the Federal Government of the Snettisham electric generating facility, also in Alaska, without satisfaction of the general rehabilitation requirement applicable to private activity bonds, because after the sale the facility's output is sold to an IOU in Juneau, Alaska.

²⁷ The five States are Alaska, California, Oregon, Texas, and Wisconsin. A non-Code exception allows the State of Texas to issue tax-exempt private activity bonds to finance limited amounts of land for veterans (in addition to any veterans mortgage bonds that Texas may issue).

transmission, and distribution facilities for private businesses engaged in the local furnishing of electricity ("local furnishers"). A business is treated as engaged in local furnishing of electricity if the service territory in which the electricity is provided does not exceed (1) two contiguous counties, or (2) a city and a contiguous county. Historically, local furnishers eligible for this tax-exempt financing have included both IOUs and independent power ventures. These bonds may be issued for the benefit of only those persons that were engaged in local furnishing of electricity in the service territory in which the new facilities will be used as of January 1, 1997, or in qualified expansions of those service territories. A "qualified expansion" is limited to service territory that is a part of a county in which the local furnisher was providing electric service on that date. For example, if a local furnisher was providing electric service to one county and a portion of a contiguous county on January 1, 1997, bonds may be issued for the continued provision of service both within that area and also for service to be provided in the remaining portion of the contiguous county in the future. In addition to persons actually engaged in local furnishing activities on January 1, 1997, the Code allows certain successors in interest to persons that qualified as local furnishers on that date to "step into the shoes" of the predecessor local furnishers provided that the service territories served otherwise satisfy the requirements for local furnishing.

Notwithstanding the general limits on service territories of local furnishers, the Code includes special rules allowing these electric service providers to transmit ("wheel") electricity through their systems, if ordered by the Federal Energy Regulatory Commission to do so under sections 211 or 213 of the Federal Power Act, provided that the size of the transmission lines or other facilities used in these wheeling activities does not exceed the capacity required to serve their otherwise qualified two county or city and a county service area.

In general, if a local furnisher ceases to qualify as such, interest on outstanding tax-exempt bonds issued for its benefit becomes taxable, and interest payments by the local furnisher on loans securing the bonds becomes nondeductible. A special election allows local furnishers to avoid these penalties if the local furnishers do not benefit from any tax-exempt bonds issued after August 19, 1996. If that election is made, in lieu of loss of tax-exemption on outstanding bonds and loss of interest deductions on underlying loans, all outstanding bonds from which the local furnisher benefits must be redeemed no later than six months after the earliest date on which redemption is permitted under the bond covenants (or the date of the election, if later). This election must be made for all local furnishing facilities of the local furnisher rather than on a facility-by-facility or bond-issue by bond-issue basis.

Additional restrictions imposed on private activity tax-exempt bonds

State volume limitations.--Issuance of most tax-exempt private activity bonds is subject to an annual volume limitation that each State receives. Each State (including local governments within the State) is allowed to issue an annual amount of these bonds not exceeding the greater of \$62.50 per resident of the State or \$187.5 million in calendar year 2001. These volume limits are scheduled to increase to \$75 per resident of the State or \$225 million beginning in calendar year 2002. Beginning in calendar year 2003, the volume limit will be adjusted annually for inflation. States may elect to carryover their unused private activity bond volume authority for

designated activities for a period of up to three years. Bond authority that is not used within the carryforward period lapses.

This limit also applies to the private business portion of certain larger governmental bond issues; such private business use in excess of \$15 million (and up to the permitted 10 percent of the issue) must receive an allocation of State volume limitation for interest on the overall bond issue to be tax-exempt.²⁸ Exceptions to the volume limitation are provided for bonds to finance airports, ports, solid waste disposal facilities (if governmentally owned), qualified 501(c)(3) bonds, and high speed intercity rail facility bonds (if governmentally owned), and bonds for environmental enhancements of hydro-electric generating facilities. Additionally, bonds for privately owned high-speed intercity rail facilities are required to receive a State volume limitation allocation only for 25 percent of the amount of the bonds.

Miscellaneous other restrictions.--Tax-exempt private activity bonds are subject to several other restrictions that do not apply to governmental bonds. These restrictions include the requirement of a public hearing and approval of their issuance by an appropriate elected governmental official, a prohibition on advance refundings,²⁹ a restriction on the term to maturity of the bonds measured by reference to the economic lives of the property to be financed, minimum rehabilitation requirements for bonds used to finance acquisition of existing property, and, in general, slightly more restrictive limits on arbitrage profits that may be earned.³⁰

²⁸ Unlike this general provision for larger governmental bond issues, the \$15 million limit on private business use of output facility bonds, described above, is an absolute limit which may not be waived by an allocation of State private activity bond volume limitation.

²⁹ The prohibition does not apply to qualified 501(c)(3) bonds. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds remain outstanding for a period greater than 90 days after issuance of the refunding bonds. Advance refundings typically are undertaken because an issuer includes provisions in its original bond documents agreeing not to redeem the bonds before expiration of a minimum period. Advance refundings are used to restructure debt service generally, to eliminate restrictive covenants contained in outstanding bond documents, or to hedge against anticipated future interest rate increases by locking in for the future what is believed to be a favorable rate. In an advance refunding both the refunded and the refunding bonds remain outstanding until the refunded bonds may be redeemed under their contractual terms. Proceeds of the refunding bonds are deposited in a yield-restricted escrow account until that time.

³⁰ The Code in general limits the amount of arbitrage profits that may be earned on tax-exempt bonds and requires that most such profits be rebated to the Federal Government. These provisions are designed to preclude issuance of tax-exempt bonds earlier than necessary for the governmental or approved private activity which is the stated purpose of the borrowing or in larger amounts than required for the purpose. Absent such restrictions, State or local governments as tax-exempt entities could borrow at tax-exempt rates and invest in, for example, taxable Federal Government debt, as an income production undertaking. Such as undertaking

Penalties for violation of tax-exempt bond restrictions after issuance

General change in use penalties and administrative alternatives

In general, the determination of whether interest on State or local government bonds is tax-exempt is made when the bonds are issued. That is, the determination is made by reference to how the bond proceeds are "to be used" (sec. 141). Intentional acts after the date of issuance to use bond-financed property (indirectly a use of bond proceeds) in a manner not qualifying for tax exemption may render interest on the bonds taxable, retroactive to the date of issuance (the "change in use rules"). Such a prohibited change in use may be illustrated by the subsequent sale of public power electric output to private businesses in a manner not qualifying for tax exemption after the bond-financed property is placed in service. Other privatization programs transferring the operation of State or local government programs to private businesses similarly can give rise to a prohibited change in use as can the sale or lease of bond-financed State or local government facilities to private businesses.

Treasury Department regulations and an accompanying Revenue Procedure, provide alternative remedies to loss of tax-exemption for certain changes in use of governmental bonds.³¹ The alternative remedies are available only if five conditions are satisfied:

- (1) The issuer of the bonds must have reasonably expected on the date of the borrowing that the bonds would not meet the private business and private loan tests (i.e., would not become private activity bonds) for their entire term;³²
- (2) The term of the bonds must not be longer than is reasonably necessary for the governmental purposes of the borrowing;
- (3) The change in use must result from a bona fide, arm's length transaction for fair market value;³³

would reduce Federal revenues by substituting tax-exempt debt for taxable debt in the hands of taxable bond investors.

³¹ Treas. Reg. sec. 1.141-12; Rev. Proc. 97-15, 1997-1 C.B. 635.

³² Absent satisfaction of this reasonable expectations test, bonds are eligible for the alternative remedies only if the issuer (1) on the issue date, reasonably expected to use the bond-financed property in a qualified use for a substantial period, (2) redeems *all* nonqualified bonds within six months of any action changing that use to a nonqualified one, (3) has no arrangement with a private business as of the issue date regarding a nonqualified change in use, and (4) otherwise meets the regulatory remedial actions. The requirement that all nonqualified bonds be redeemed includes redemption in cases where bond-financed property is disposed of for less than the unpaid bond amount. In such cases, the issuer must make up any shortfall in the disposition proceeds from other sources to avoid bond interest being rendered taxable.

- (4) Any disposition proceeds must be treated as "gross proceeds" of the bond issue, subject to the Code arbitrage rules; and
- (5) The bond proceeds must have been spent for the purpose of the borrowing before the change in use occurs (unless the bonds are redeemed) (Treas. Reg. sec. 1.141-12(a)).

If the five conditions are satisfied, four possible alternative remedies to loss of tax-exemption are available for post-bond-issuance actions violating the private business tests. First, all currently callable bonds may be redeemed within 90 days after the change in use and all other bonds may be defeased with a yield-restricted escrow and called on the first date when that action is permitted under the bond terms (Treas. Reg. sec. 1.141-12(d)).³⁴ Second, in the case of dispositions entirely for cash where the bond issuer expects to spend the disposition proceeds within two years after the change in use, the disposition proceeds may be treated as bond proceeds and used accordingly, subject to all of the Code's tax-exempt bond provisions (Treas. Reg. sec. 1.141-12(e)). To the extent the disposition proceeds are not used for a qualifying use within the two-year period, bonds must be redeemed.

A third remedy provides that loss of tax-exemption will not occur if bond-financed property is transferred in a transaction constituting a change in use from a governmental use to a use that is eligible for financing with tax-exempt private activity bonds provided that the issuer treats the bonds as reissued on the date the change in use occurs and satisfies rules applicable to the revised use of the bonds (including where applicable, allocation of State private activity bond volume limitation) (Treas. Reg. sec. 1.141-12(f)).³⁵ The final alternative remedy to loss of tax-exemption allows the issuer to pay the Federal Government an amount equal to lost tax revenues from allowing nonqualified tax-exempt bonds to remain outstanding as tax-exempt (Rev. Proc. 97-15).

Additional change in use penalties for private activity tax-exempt bonds

In addition to loss of tax-exemption on bond interest, conduit borrowers receiving tax-exempt private activity bond financing lose interest deductions on their underlying loans if the use of the bond-financed property changes to a non-qualified use after issuance (the "additional change-in-use rules"). For example, if the output of an IOU facility for the local furnishing of electric service is used to provide service beyond the permitted two county or city and a county

³³ The determination of fair market value may take into account restrictions on the use of the bond-financed property that serve "a bona fide government purpose."

³⁴ The maximum period of the escrow account may not exceed 10-1/2 years.

³⁵ Because the original tax-exempt bonds remain outstanding, a purchaser of property financed with tax-exempt bonds qualifying for this remedy is not permitted to finance any acquisition costs with additional tax-exempt bonds (e.g., tax-exempt exempt-facility bonds could not be issued to finance the transfer of a governmental solid waste disposal system to a private business).

area, interest paid by the IOU on loans underlying the tax-exempt bonds is nondeductible (sec. 150(b)(4)).³⁶

B. Tax Provisions Primarily Affecting Investor-Owned Utilities

1. Cost recovery of property used in the production, transmission, and distribution of electricity

Tax depreciation generally

A taxpayer generally must capitalize the cost of property used in a trade or business and is allowed to recover such cost over time through allowances for depreciation or amortization. Code section 167 allows annual depreciation deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the capitalized cost of property. Theoretically, the exhaustion, wear and tear, or obsolescence of depreciable property would be most accurately determined by "economic depreciation." Under economic depreciation, property is valued and "marked-to market" on an annual basis and any decrease in value from one year to the next is allowed as a depreciation deduction. Economic depreciation generally is conceded to be difficult to administer due to the case-by-case, annual valuations of each property that would be required.

Prior to 1981, taxpayers were allowed to depreciate the cost of property (net of salvage value) over the useful life of the property (i.e., the period over which the property is reasonably expected to be useful to the taxpayer in its trade or business). This depreciation method, known as "facts and circumstances" depreciation, allows the taxpayer to estimate (and re-estimate) the useful life and salvage value of property, often resulting in disputes between taxpayers and the Internal Revenue Service ("IRS"). Under facts and circumstances depreciation, reasonable allowances for depreciation could be computed using a straight-line or an accelerated method (such as a declining balance method or a sum of the years-digits method).

In order to minimize some of these controversies, the IRS published depreciation guidelines in 1962.³⁷ These guidelines assigned useful lives to a few common types of assets, and grouped other assets based on the activity in which they were used. The useful lives provided by these guidelines formed the basis of the asset depreciation range ("ADR") system that could be elected by taxpayers for property placed in service after 1970 and before 1981.

Facts and circumstances depreciation was repealed by the enactment of the Accelerated Cost Recovery System ("ACRS") in 1981. For property placed in service after 1980 and before

³⁶ An exception to this rule, enacted in 1996 and described above, provided that this penalty and loss of tax-exemption on bonds not apply to bonds issued before August 20, 1996, in the case of service territory expansions by local furnishers of electricity or gas that elect to forego additional tax-exempt financing from bonds issued after August 19, 1996, and satisfy certain other conditions.

³⁷ Rev. Proc. 62-21, 1962-2 C.B. 418.

1987, ACRS generally provides that depreciation is computed by applying specific recovery allowances over specified periods for various types of depreciable property. ACRS provided accelerated methods and 10- and 15-year recovery periods for "public utility property;" most other tangible personal property had a 5-year recovery period. Depreciation under ACRS generally recovered the cost more quickly than under either economic or facts and circumstances depreciation.

For property placed in service after 1986, depreciation allowances for tangible property generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of Code section 168. MACRS is similar to ACRS, but generally provides less generous depreciation allowances.³⁸ Under MACRS, property is assigned a recovery period that generally is based on the class life of the property under the asset depreciation range ("ADR") system in effect before 1981. The MACRS recovery periods range from 3 to 50 years. The recovery periods for some types of property (such as alternative energy and biomass property described in the Table 1 below) are prescribed by statute. The depreciation method generally applicable to property with a recovery period of less than 15 years is the 200-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction). The 150-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction) applies to property with recovery periods of 15 or 20 years, and the straight-line method applies to property with a recovery period over 20 years (generally, real property). In addition, MACRS removed the distinction between public utility property and any other property used to provide similar services.

Tax depreciation rules applicable to utility property

The MACRS recovery periods and depreciation methods for property used in the production, transmission, and distribution of electricity are described in Table 1 below.³⁹

³⁸ The depreciation deductions computed under section 168 for regular tax purposes may be adjusted under the alternative minimum tax ("AMT"). The AMT generally is a separate system that imposes tax at a lower rate upon a broader base of income than does the regular tax. For property placed in service after December 31, 1998, AMT depreciation deductions are to be computed using the recovery periods prescribed by section 168 and the 150-percent declining balance method (or the straight-line method for property subject to such method for regular tax purposes). For property placed in service before January 1, 1999, AMT depreciation deductions generally are computed using recovery periods longer than those prescribed for regular tax.

³⁹ Rev. Proc. 87-56, 1987-2 C.B. 674.

**Table 1.--Recovery Periods and Depreciation Methods Applicable to
Electric Utility Property Under MACRS**

Asset Class	Description of Asset	Recovery Period (years)	Depreciation Method
49.11	Electric Utility Hydraulic Production Plant (includes assets used in hydraulic power production of electricity for sale, including related land improvements, used as dams, flumes, canals and waterways)	20	150% declining balance
49.12	Electric Utility Nuclear Production Plant (includes assets used in nuclear power production and electricity for sale and related land improvements; does not include nuclear fuel assemblies)	15	150% declining balance
49.121	Electric Utility Nuclear Fuel Assemblies (includes initial core and replacement core nuclear fuel assemblies (i.e., the composites of fabricated nuclear fuel and container) when used in boiling water, pressurized water, or high temperature gas reactor used in the production of electricity; does not include nuclear fuel assemblies used in breeder reactors)	5	200% declining balance
49.13	Electric Utility Steam Production Plant (includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle, with a conventional steam unit and related land improvements; also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others)	20	150% declining balance
49.14	Electric Utility Transmission and Distribution Plant (includes assets used in the transmission and distribution of electricity for sale and related land improvements; generally excludes clearing initial grading land improvements)	20	150% declining balance
	Electric Utility Combustion Turbine		

Asset Class	Description of Asset	Recovery Period (years)	Depreciation Method
49.15	Production Plant (includes assets used in the production of electricity for sale by the use of such prime movers as jet engines, combustion turbines, diesel engines, gasoline engines, and other internal combustion engines, their associated power turbines, and/or generators, and related land improvements; does not include combustion engines operated in a combined cycle with a conventional steam unit)	15	150% declining balance
-----	Alternative Energy Property (sec. 168(e)(3)(B)(vi)(I) and (III)) (generally, equipment that uses solar or wind energy to generate electricity; equipment used to produce, distribute, or use energy derived from a geothermal deposit up to the point of the electrical distribution stage; or equipment that converts ocean thermal energy into usable energy at one of two locations designated by the Secretary Treasury)	15	200% declining balance
-----	Biomass Property (sec. 168(e)(3)(B)(vi)(II)) (assets described in section 48(l)(15) (as in effect on November 5, 1990), and is a qualifying small production facility within the meaning of section 3(17)(c) of the Federal Power Act, (16 U.S. C. 796(17)(C) (as in effect on September 1, 1986))	5	200% declining balance

In addition, under present law, a taxpayer may elect to amortize (over 60 months) the amortizable basis of any certified pollution control facility (sec. 169). A certified pollution control facility is a facility (1) to abate or control water or air pollution, (2) that is State- or Federally-certified for such purposes, (3) that is used in connection with a plant or other property placed in service before 1976, and (4) that does not extend the useful life, reduce the operating cost, or alter the manufacturing or production process of the plant or other property. The amortizable basis is the cost of such facility. However, if the facility has a useful life greater than 15 years, the amount amortizable over 60 months is equal to the cost of the property

multiplied by a fraction equal to 15 divided by the useful life.⁴⁰ Any cost not amortizable under section 169 may be depreciated as tangible property under sections 167 and 168.

Pollution control facilities often are placed in service with respect to public utility property (e.g., coal scrubbers used in connection with coal-fired electric generating facilities). Such facilities generally have useful lives greater than 15 years. Thus, under present law, only a portion of the cost of such facilities may be amortized over 60 months, with the remainder determined under MACRS (generally, using the 150-percent declining balance method over 15 or 20 years).

Normalization of tax benefits derived from accelerated tax depreciation

In order for public utility property to be eligible for the more favorable depreciation allowances available for tax purposes (relative to the depreciation allowances used for ratemaking or financial statement purposes), the tax benefits of accelerated depreciation must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.⁴¹

Under present law, the tax benefits of accelerated depreciation are considered to be normalized only if three requirements are satisfied (sec. 168(i)(9)(A)). First, the tax expense of the public utility for ratemaking purposes must be computed by using the same depreciation method that is used in determining depreciation for ratemaking purposes and by using a recovery period that is no shorter than the useful life used in determining depreciation for ratemaking purposes (which generally results in depreciation being determined over a relatively long useful life and using the straight-line method). Second, the difference between the actual tax expense computed using tax depreciation and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve. Third, in determining the rate of return of a public utility, the public utility commission may not exclude from the rate base an amount that exceeds the addition to the deferred tax reserve for the period used in determining the tax expense for ratemaking purposes. In addition, any ratemaking procedure or adjustment with respect to a utility's tax expense, depreciation expense, or reserve for deferred taxes must also be consistently used with respect to the other two items and rate base (sec. 168(i)(9)(B)).

Any violation of these requirements results in the loss of the application of accelerated tax depreciation for the applicable public utility property and the depreciation allowances for such property must be determined for Federal income tax purposes under the method used for regulatory purposes (secs. 168(f)(2) and (i)(9)(C)). Under present law, public utility property is defined as property used predominantly in the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewage disposal services; (2) gas or steam through a local distribution

⁴⁰ In addition, section 291(a)(5) requires corporate taxpayers to reduce the amount amortizable under section 169 by twenty percent of the otherwise permitted amount.

⁴¹ Similar rules are provided for certain public utility property placed in service prior to 1986 (the first year that MACRS was applicable).

system; (3) telephone services; (4) other communications services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or (5) transportation of gas or steam by pipeline, if the rates for such furnishing or sale are 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 a State or political subdivision thereof (sec. 168(i)(10)).

Example of normalization method of accounting

In order to understand the effect of the Federal income tax normalization requirement on the determination of rates charged for utility services, an understanding of the ratemaking process and an alternative method of accounting for accelerated tax depreciation benefits (the "flow-through" method) is helpful.

The ratemaking process—in general

The ratemaking process is a means by which the revenue requirements of a utility are determined. In setting utility rates, public utility commissions generally attempt to allow the utility to collect enough charges from utility customers to (1) recover operating expenses (the cost of service element), and (2) provide a fair rate of return to investors (the rate of return element).

Expenses taken into account in determining the cost of service element include labor, fuel, materials, depreciation on utility plant and equipment, and income tax expense. The rate of return element typically is computed by multiplying (1) an allowable rate of return (as determined by the public utility commission) times (2) the rate base. The allowable rate of return is generally determined with reference to the utility's weighted cost of borrowing plus an appropriate return on equity capital. Rate base is usually computed as the working capital of the utility, plus the original cost of utility plant and equipment, less accumulated regulatory depreciation, and less the deferred tax reserve (as described below). The deferred tax reserve is deducted from rate base for purposes of computing the rate of return element because the reserve is considered to be a no-cost source of capital. Thus, Federal income taxes are an important factor in determining the rates a utility may charge its customer because (1) income tax expense is considered a recoverable cost of service, and (2) deferred income taxes reduce the rate base upon which an allowable rate of return is applied.

Methods of accounting for tax depreciation: flow-through vs. normalization

Flow-through accounting.--The determination of the amount of Federal income taxes reflected in cost of service and rate base depends on the treatment of depreciation of utility property. The use of an accelerated depreciation method for Federal income tax purposes results in an actual Federal income tax liability that differs from the Federal income tax liability that would have been incurred if the typically slower depreciation methods used for regulatory purposes had been used for tax purposes. In general, in the first few years after property has been placed in service, the Federal income tax liability will be lower than if the regulatory

depreciation schedule had been used. The Federal income tax liability will be greater in later years when the tax depreciation allowances are less than the regulatory depreciation allowances.

Flow-through accounting treats the actual Federal income tax liability of the regulated utility as reported on its tax return as the utility's tax expense in determining appropriate utility rates. Under flow-through accounting, the tax benefits of accelerated depreciation are taken into account as they are claimed in determining utility rates. Thus, under flow-through accounting, utility rates are lower for those consumers who are charged for service in the earlier years of the useful life of the utility property (relative to those consumers who are charged for service in later years).

Normalization accounting.--In contrast, under normalization accounting, the utility's tax expense for ratemaking purposes is determined by using regulatory depreciation allowances. The use of regulatory depreciation allowances generally results in the spreading of the tax benefits of accelerated tax depreciation over the regulatory life of the property. The normalization method for accelerated depreciation requires adjustments to actual Federal income tax liability to arrive at the regulatory tax expense and adjustments to rate base. The accumulation of the differences between regulatory tax expense and actual Federal tax liability creates a deferred tax reserve that represents both accumulated Federal income tax savings and expected future Federal tax liabilities. Normalization accounting is consistent with generally accepted accounting principles used to prepare financial accounting statements.

Example.--Assume a calendar year regulated utility placed property costing \$100 million in service in 1997. For regulatory (book) purposes, the property is depreciated over 10 years on a straight-line basis with a full year's allowance in the first year. For tax purposes, the property is 5-year property and is recovered using the straight-line method, with a full year's deduction allowed in 1997.⁴² Assuming a tax rate of 35 percent for all years, deferred taxes (the tax rate times the difference between tax and book depreciation) would be computed as shown in Table 2.

⁴² The 5-year tax and 10-year book lives, the straight-line tax method and the full depreciation allowance for the first year are used for illustration purposes only. In general, public utility property is 5-, 15-, or 20-year property under MACRS, is depreciated using an accelerated depreciation method, and is subject to a half-year placed-in service convention. For regulatory purposes, public utility property may have a life of 30 years or more.

**Table 2.--Deferred Tax Reserve Assuming Constant Tax Rates
(Millions of Dollars)**

	1997	1998	1999	2000	2001	2002	2003-06	1997-06
Tax depreciation	20	20	20	20	20	0	0	100
Book depreciation	10	10	10	10	10	10	40	100
Timing difference	10	10	10	10	10	[10]	[40]	----
Tax rate	.35	.35	.35	.35	.35	.35	.35	----
Annual adjustments to reserve	3.5	3.5	3.5	3.5	3.5	[3.5]	[14.0] ¹	
Deferred tax reserve	3.5	7.0	10.5	14.0	17.5	14.0	----	----

¹ The deferred tax reserve is reduced by \$3.5 million a year for 2003 through 2006 so that no reserve exists as of December 31, 2006.

Under flow-through accounting, Federal tax expense is determined with reference to accelerated tax depreciation and no deferred tax reserve is created. Under normalization accounting, Federal tax expense is determined with reference to book depreciation and a deferred tax reserve is created to account for the accumulated tax benefits arising from the differences between tax and book depreciation. In Table 2, above, the use of accelerated tax depreciation in the first five years of the property's life results in a deferred tax reserve of \$17.5 million at the end of 2001 which, under normalization accounting, is then reduced over the remaining regulatory life of the property.

Generally, if normalization accounting is followed in the ratemaking process, the \$17.5 million deferred tax reserve at December 31, 2001, would have been included as a portion of income tax expense in computing cost of service for years 1997 through 2001. The \$17.5 million deferred tax reserve generally would have also reduced the rate base over that same period. In that case, rate base with respect to this property, as of December 31, 2001, would be \$32.5 million (\$100 million original cost, less \$50 million accumulated book depreciation, less the \$17.5 million deferred tax reserve).

Normalization accounting methods adjust for various timing differences between tax and regulatory accounting of utilities. The benefit of the interest-free loan created by accelerated cost recovery for tax purposes could be distributed to consumers in a variety of ways. However, normalization as applied to accelerated depreciation for Federal income tax purposes attempts to distribute to consumers the benefit of the interest-free loan made to the utility over the entire useful life of the asset. Because accelerated tax benefits are front-end loaded, utility rates under the normalization method are higher in the early years of the life of the property than the rates would be under the flow-through method. However, as these tax benefits reverse (i.e., as ratemaking depreciation exceeds tax depreciation), utility rates under the normalization method become lower than the rates computed under the flow-through method. Theoretically, because

the normalization method results in decreases to a utility's rate base that are not present under the flow-through method, the present value of utility rates over the life of the property under the normalization and flow-through methods should be equal, when discounted at the rate of return that is applied to rate base for ratemaking purposes.

It has been argued that a purpose of normalization is to ensure that the capital subsidy of accelerated tax depreciation provides an investment incentive for regulated utilities. Some reason that if tax benefits were flowed through to ratepayers immediately, the utility would have no incentive to invest in property to which such benefits accrue. Proponents of normalization accounting claim that even if the normalization and flow-through methods theoretically should equalize rates over time on a present-value basis, practical aspects of the ratemaking process may distort such results.

2. Other tax provisions of industry concern

(a) Nuclear decommissioning

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception to those rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future payment costs. Taxpayers who do not elect this provision are subject to the general rules in the 1984 Act.

A qualified nuclear decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, and management costs of the fund, and for making investments. The qualified fund is prohibited from dealing with the taxpayer that established the fund. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.⁴³

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers. Funds withdrawn by the taxpayer to pay for decommissioning expenses are included in the taxpayer's income and the taxpayer is entitled to a deduction for decommissioning expenses as economic performance of those costs occurs.

⁴³ As originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present-value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent and removed the restrictions on the types of permitted investments that the fund can make.

A taxpayer's contributions to the qualified fund may not exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. Additionally, in order to prevent accumulations of funds over the remaining life of a nuclear power plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum contribution that may be made to the qualified fund in any year. The ruling amount may not exceed the amount necessary to fund a percentage of decommissioning costs equal to the percentage of the useful life of the nuclear power plant for which the qualified fund is in effect.⁴⁴ A taxpayer is required to include in gross income the amount of nuclear decommissioning costs included in cost of service for ratemaking purposes (sec. 88).

If the decommissioning fund fails to comply with the qualification requirements or when the decommissioning is substantially completed, the fund's qualification may be terminated. The amounts in the fund must then be included in income of the taxpayer upon termination.

A qualified decommissioning fund may be transferred in connection with the sale, exchange or other transfer of the nuclear power plant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified decommissioning fund and the transferee will take the transferor's basis in the fund.⁴⁵ The transferee is required to obtain a new ruling amount from the IRS, or accept a discretionary determination by the IRS.⁴⁶

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning purposes in excess of the amount allowed as a deductible contribution to a qualified decommissioning fund. In addition, the taxpayer may have set aside funds prior to the effective date of the qualified decommissioning fund rules. The treatment of these pre-1984 amounts varies. Some taxpayers may have received no tax benefit while others may have

⁴⁴ For example, in 1979 ElectriCo places in service a nuclear power plant with an estimated useful life of 20 years. In 1984, when the estimated remaining useful life is 15 years, ElectriCo establishes a qualified nuclear decommissioning fund with respect to the plant. ElectriCo's contribution to the fund will be limited to the amount necessary to fund 75% (15/20) of the cost of decommissioning.

⁴⁵ Treas. Reg. sec. 1.468A-6.

⁴⁶ Treas. Reg. sec. 1.468A-6(f).

deducted such amounts or excluded such amounts from gross income.⁴⁷ These nonqualified funds are not eligible for the special rules that apply to qualified decommissioning funds. Since 1984, no deduction has been allowed with respect to the contribution or segregation of nonqualified funds, and the income on nonqualified funds is taxed to the taxpayer at the taxpayer's marginal rate.

(b) Income recognition on the provision of services

Income attributable to the sale or furnishing of utility services to customers by an accrual basis taxpayer must be recognized no later than the taxable year in which such services are provided (sec. 451(f)). The taxable year in which services are provided may not be determined by reference to either (1) the period in which the customers' meters are read or (2) the period in which the customer is billed. The provision of electricity is considered a utility service whose sale is subject to this rule. The IRS has previously taken the position that providers of electricity generally are required to use the accrual method of accounting.⁴⁸

The rule requiring recognition of utility income in the taxable year in which the service is provided was enacted as part of the 1986 Act, to ensure a better matching of income and expense, and to eliminate a source of controversy between utilities and the IRS.⁴⁹ Before to the enactment of this rule, an electric utility typically did not recognize income until the customer's meter was read or the customer was billed. As the cost of generating the electricity was typically deducted at the time of generation, a deferral of income was believed to result. This deferral was understood to be unique to the utility industry, and not generally available to other providers of goods and services.

(c) Conservation payments

Residential utility customers are not required to include in taxable income any subsidy provided by public utilities to their customers for the purchase or installation of energy conservation measures that are designed to reduce the consumption of electricity or natural gas, or to improve the management of energy demand, with respect to a dwelling unit (sec. 136)). Before 1997, a partial exclusion for energy conservation payments for nonresidential purposes also was available. In the absence of the statutory rule allowing exclusion, customers that receive such subsidies generally would be required to include them in income. Examples of

⁴⁷ Prior to July 17, 1984 (the date of enactment of the Deficit Reduction Act of 1984), accrual basis taxpayers could deduct items without regard to the time they were economically performed. Some taxpayers may have taken the position that amounts irrevocably set aside for nuclear decommissioning purposes prior to July 17, 1984, were deductible. In addition, other taxpayers may have taken the position, prior to the enactment of section 88 on July 18, 1984, that customer chargers for nuclear decommissioning costs were not includable in taxable income.

⁴⁸ Technical Advice Memorandum ("TAM") 9527003 (February 15, 1995).

⁴⁹ See, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987, at 542.

energy conservation measures included under this rule could include energy efficient heating and air conditioning systems, special thermostats designed to reduce the consumption of energy, and devices for the capture and use of waste heat.

(d) Customer deposits and prepayments

A taxpayer generally is required to include in income any prepayments for goods or services it receives from its customers in the year of receipt. A security deposit, on the other hand, need not be included in income on receipt. Whether an amount received from a customer is a prepayment or a deposit depends upon whether the taxpayer has complete dominion over the funds.⁵⁰ A taxpayer is not considered to have complete dominion over funds if it has an obligation to repay the funds, whether or not the purpose of the transfer of the funds is to guarantee the customer's payment for goods or services received. These rules apply to both regulated utility and non-utility taxpayers.

(e) Cost of service adjustments

As described above (Part II.B.1.), rates charged by regulated public utilities are typically established at a level that allows the utilities to recover their costs, including the cost of fuel, and to earn a return on their investment. Because rates are established before the costs of generating the electricity are known with certainty, an estimate of those costs must be used. Where the estimate overstates a utility's costs, allowing the utility to over recover its costs, the amount of the over recovery generally is required to be returned to the ratepayers through a cost of service adjustment, either as a refund or through lower rates for future service.

The Federal income tax treatment of cost of service adjustments depends upon the method in which the utility is required to restore the amount of the over recovery to its ratepayers. Where the cost of service adjustment is accomplished through the reduction of rates on future sales, the taxable income of the utility is determined by the amount it charges for the electric service, without adjustment for the over recovery or its refund.⁵¹ On the other hand, if the repayment of the over recovery is an enforceable obligation of the utility, and must be returned to the ratepayers with interest, the courts have held that the utility derives no benefit from the overpayments and is not required to include them in income in the period the overpayments are charged to customers.⁵² If the overpayments are not included in income in the period they are originally charged, no deduction is allowed in the later period in which they are refunded.

For example, assume two equivalent utilities have received rate orders from the respective public utility commissions based on the same estimate of fuel costs. Assume further that actual fuel costs are 10 percent less than estimated, resulting in an over recovery of costs in

⁵⁰ *Indianapolis Power v. Commissioner*, 493 U.S. 203 (1990).

⁵¹ *Roanoke Gas Co. v. United States*, 977 F. 2d 131 (4th Cir., 1992).

⁵² *Houston Industries v. United States*, 125 F. 3d 1442 (Fed. Cir. 1997).

the amount of \$1,000,000 for the year for each utility. Both utilities are required to refund the over recovery of costs to their ratepayers. Utility A will refund the over recovery by reducing future rates so that estimated fuel costs are under recovered in the following year. Utility A is required to include the \$1,000,000 in over recoveries in income in the first year, but will report income of \$1,000,000 less than it would otherwise expect to in year 2 when the over recovery is refunded through the lower rates.

The law in Utility B's State requires it to segregate its over recovery of costs and to refund that amount, plus interest, to its ratepayers when ordered to do so by its public utility commission. The PUC orders the refund to be made as a credit on the customers' bills in the following year. Utility B is not required to include the amount of the overpayment in income in the first year, but may not deduct any overpayment in subsequent years.

If a utility originally included the overpayment in income because it appeared that it had an unrestricted right to the funds, and it is later established that the utility did not have such an unrestricted right and is obligated to refund these amounts, section 1341 may apply. If applicable, section 1341 allows tax in the year of repayment of the overcharge to equal the lesser of: (1) the amount due if the restoration of the overcharge were treated as a deduction in the year of its restoration; or (2) the amount due if the overcharge were not allowed as a deduction, less the decrease in Federal income tax that would result if the over recovery had been excluded from income in the prior year.

(f) Cancellation of supply contracts

Regulated utilities frequently enter into long-term, fixed price contracts in order to guarantee supplies of fuel. In addition, utilities may have been required to enter into long-term contracts to purchase the output of cogeneration and other small power producers under the Public Utility Regulatory Policies Act of 1978 ("PURPA"). If the payments required by these contracts require the payment of above-market rates, or require the purchase of electricity at the time the utility has excess generating capacity, the utility may seek to cancel the contract through the payment of a settlement or damages to the other party.

The IRS has allowed taxpayers to deduct amounts paid to buy out and terminate supply contracts as ordinary and necessary business expenses in the year they are paid.⁵³ However, the IRS also has ruled that, where the utility enters into a revised contract with the same supplier as part of the transaction canceling the first contract, the cost of canceling the first contract should be capitalized and recovered over the length of the new contract.⁵⁴

(g) Contributions in aid of construction

In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. For this purpose, contributions to the capital of a corporation do not include any

⁵³ PLR 9615028 (January 3, 1996) and PLR 199913032 (December 21, 1998).

⁵⁴ TAM 9334005 (May 14, 1993).

contribution in aid of construction or any other contribution as a customer or potential customer, except in the case of water and sewerage disposal utilities (sec. 118)). The basis of any property that is acquired as a nontaxable contribution to capital, or with the proceeds of a nontaxable contribution to capital, is zero (sec. 362)).

For example, if an IOU requires new customers to pay the cost of extending the existing wires to the customer's premises, the IOU is required to include such amount in income and may depreciate the cost of the additional wires. The contribution is denied tax free treatment (under Code section 118) because the contribution was made by a customer in that role. On the other hand, a contribution received by an IOU from an independent power producer as reimbursement for construction of interconnection facilities would not be disqualified automatically from nontaxable contribution treatment, since the contribution is being made by a supplier in its capacity as a supplier, and not by a customer.⁵⁵

(h) Involuntary conversions

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar to, or related in service or use to, the converted property. To qualify, the replacement property must be acquired within a specified period of time, generally two years. The taxpayer's basis in the replacement property generally is the same as taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. Involuntary conversions include the loss of property as a result of its destruction, theft, seizure, requisition or condemnation. Involuntary conversions also include sales of property under the threat or imminence of requisition or condemnation (sec. 1033(a)). Sales of property to a private party in order to comply with a government order, such as an order of divestiture in an antitrust case, generally have not been considered involuntary conversions for this purpose.

3. Deferred tax accounts: financial, regulatory, and tax accounting

Financial accounting

A deferred tax account⁵⁶ is required whenever temporary differences exist between Federal income tax accounting and the financial accounting treatment of an item. Where the difference will result in taxable amounts in the future, a deferred tax liability is created. For example, if accelerated depreciation deductions are allowed for Federal income tax purposes, but not for financial accounting purposes, additional taxes will have to be paid in the future when the depreciation deductions that were accelerated into the current period are not available. These taxes, measured using current income tax rules and rates, are recognized as a deferred tax

⁵⁵ PLR 9327019 (April 6, 1993), Notice 88-129, 1988-2 C.B. 541.

⁵⁶ Financial accounting for income taxes is governed by Financial Accounting Statement 109 (FAS 109), published by the Financial Accounting Standards Board. The rules herein stated are derived from FAS 109.

liability. The financial accounting expense attributable to these additional taxes is recognized currently, making financial accounting tax expense for the period in which the accelerated depreciation is available for Federal income tax purposes greater than the amount actually paid.

A deferred tax asset is recorded for temporary differences that will result in deductible amounts in the future, as well as the anticipated reduction in future tax liability attributable to the carryforward of such items as net operating losses and tax credits. If it is more likely than not that the benefit of some or all of the deferred tax asset will not be realized, a valuation allowance is required to reduce the balance in the account to the amount that is likely to be realized.

Deferred tax assets in the public utility industry are frequently associated with the unamortized portion of investment tax credits that were claimed for Federal income tax purposes in earlier years. IOUs generally are allowed to elect to include the benefit attributable to the investment tax credit in the year it is claimed for Federal income tax purposes, or to amortize the benefit over the useful life of the asset on which the credit was claimed. Financial accounting typically will use amortization of the benefit from the investment tax credit where that method is used for regulatory accounting purposes.

Regulatory accounting

Deferred tax accounts also are established for regulatory accounting purposes to reflect temporary differences between Federal income tax accounting and regulatory accounting. Such accounts are described in Part II.B.1. of this pamphlet, with respect to the normalization method of accounting.

4. General corporate restructuring issues

In general

The disposition or combination of businesses and assets can be structured in various ways, producing different Federal income tax results. Assets or businesses can be disposed of for cash, or through other transactions that are fully taxable. In a fully taxable transaction, gain or loss is recognized in full on the transfer of assets or corporate stock interests. Assets or stock purchased in a taxable transaction obtain a fair market value basis. Depreciable assets then can be depreciated by the purchaser over the appropriate recovery period, or resold for their acquisition basis without further gain or loss. Goodwill, customer base, and most other intangible assets generally are depreciable over a 15-year period; however assets such as interests in land and stock are not depreciable.

Dispositions or combinations also can often be structured in a form that is not immediately taxable. For example, assets or stock generally may be transferred to a partnership in exchange for a partnership interest without incurring tax on the transfer. The partners often can achieve a significant amount of flexibility in the division of their interests in the ongoing venture through different classes of partnership interests. There are certain restrictions on transactions that result in the transfer of appreciated property from one partner to another within specified periods, and also certain restrictions on the nature of certain allocations. However, the

partnership form of venture often is considered a fairly flexible form for combination and restructuring of interests.

Corporate combinations and restructurings also can often be structured in a tax-free manner. Generally, contributors can form new ventures or provide for a change in the nature of ownership in an old venture through the various corporate reorganization provisions, or through provisions permitting the transfers of stock or assets tax-free to a corporation controlled by the transferors, in exchange for certain consideration. Generally, stock can be received tax free in such situations (and, in limited cases, securities to the extent of certain securities transferred). Under the Taxpayer Relief Act of 1997 (the "1997 Act"), a limited type of preferred stock that does not participate to any significant extent in corporate growth and that is likely to be (or can be at the option of the holder) redeemed within 20 years could be taxable. In general, however, stock consideration, including stock representing varying interests in the underlying business or businesses, can be received tax free if the requisite continuity or ownership requirements are met.

A corporation also can separate existing businesses through the tax-free "spin off" of a 5-year active trade or business to its shareholders. However, under the 1997 Act, certain planned or related changes of 50 percent or more of the ownership of the distributed or distributing corporation can result in corporate-level tax being imposed on a spin-off if there is gain at the corporate level.

Taxable sales could generate losses, though use of such losses could be limited if there are not gains or other income against which they can be applied. Certain limitations also apply to the future use of existing (or certain "built-in") losses at the corporate level, if a sufficient amount of corporate stock is transferred (rather than the underlying corporate assets) whether in a taxable or nontaxable transaction. Generally, if more than 50 percent of the ownership of a corporation changes hands within a 3-year period, limitations on the use of losses after such ownership change may apply (sec. 382). These limitations are significantly relaxed if the transfer occurs in the context of certain bankruptcy proceedings.

Some situations may involve new ventures between tax-exempt and taxable entities. Tax-exempt entities holding equity interests in certain business activities conducted in partnership form may be subject to unrelated business taxable income. However, tax-exempt entities generally can sell existing tax-exempt assets without tax to taxable entities that then obtain a fair market value basis. Tax-exempt entities also can hold corporate stock, and generally can hold debt interests in any form of venture, without tax, subject to certain rules such as those relating to debt-financed activities.

Special rules relating to utilities

Public utilities that are corporations are allowed a dividends paid deduction on certain preferred stock issued before October 1, 1942, or issued after that date to the extent the preferred stock refunded or replaced certain debentures issued before that date (sec. 247). A special dividends received deduction computation applies to corporate holders of such stock (sec. 244).

C. Tax Provisions Affecting Electric Cooperatives

1. Overview of cooperatives and electricity

Brief description of cooperatives

Generally, cooperatives are formed under State “cooperative statutes.” Federal tax rules only require that the entity operate on a cooperative basis, which is not defined. Nonetheless, the principal criteria for determining whether an entity is operating on a cooperative basis are ownership of the cooperative by persons who patronize the cooperative and return of earnings to patrons in proportion to their patronage. The Internal Revenue Service requires that cooperatives must operate under the following principles: (1) subordination of capital in control over cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost). Cooperatives may have several types of members.⁵⁷ In general, members are those who voice management of the cooperative and who share in patronage capital. Income from sale of electricity may be member or nonmember income, depending on the membership status of the purchase consumer. A municipal corporation may be a member or nonmember of a cooperative.

Structure of electric cooperatives

Cooperatives are involved in all four primary functions of the electricity industry: generation, transmission, distribution and retailing. Generation and transmission cooperatives (“G&Ts”) construct and operate power plants (alone or in arrangements with other utilities) and sell electricity at wholesale prices to their distribution cooperatives, which in turn sell electricity retail to consumers. Each cooperative may, in turn, be a member of other cooperatives, including cooperative subsidiaries. G&Ts often join with other utilities to build and operate power generating stations. The joint ventures may own the station as tenants in common, operating the station and sharing its capacity and energy according to various operating agreements, station agreements and load management agreements. In approximately 21 States, the State public utility commission regulates rates charged by electric cooperatives.⁵⁸

⁵⁷ Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

⁵⁸ Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

2. Present and prior law

Exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members.

Taxation of cooperatives and their patrons before enactment of Subchapter T

Before 1951, cooperatives were exempt from Federal income tax. In 1951, Congress passed legislation imposing a corporate income tax on cooperatives, except for so-called "exempt cooperatives." This legislation, together with prior Treasury Department rulings, were thought to impose income tax on all earnings of cooperatives (to the extent they reflected business activity) on either the cooperative or their patrons.

However, several court cases held that noncash allocations of patronage dividends were not taxable to the patrons, even though those patronage dividends were deductible by the cooperative.⁵⁹ In 1959, the Treasury Department issued regulations to conform the income tax regulations to those decisions. Under these regulations,⁶⁰ amounts allocated to patrons of a cooperative with respect to supplies, equipment, or services, the cost of which were deductible as incurred in a trade or business or for the production of income were includable as ordinary income to the extent the allocations were paid in (1) cash, (2) the fair market value of any merchandise received, (3) the fair market value of any revolving fund certificate, retain certificate, certificate of indebtedness, letters of advice, capital stock, etc., to the extent the allocations were paid with such documents, except that any allocations that are paid under conditions beyond the control of the patron were considered not to have any value. Amounts allocated by a cooperative to patrons for supplies, etc., which were not deductible were not includable in the income of the patron. Amounts allocated by a cooperative to patrons for the purchase of a capital asset reduce the basis of the capital asset to the patron.

Taxation of cooperatives and their patrons after enactment of Subchapter T

As a result of the cases described above, in 1962, Congress enacted a new subchapter--Subchapter T--to the income tax (Chapter 1) to assure income of a cooperative is taxed either to the cooperative or its patrons (secs. 1381-1388). Cooperatives, including tax-exempt farmers' cooperatives, and their members are subject to special tax rules under subchapter T of the Code (sec. 1381 et seq.). In general, these provisions operate to treat the cooperative more like a conduit than a separate taxable business enterprise.

⁵⁹ See *Long Poultry Farm v. Commissioner*, 249 F. 2d 726 (4th Cir., 1957), 57-2 U.S.T.C. 10,048; aff'g, 27 T.C. 985 (1957); *B. A. Carpenter v. Commissioner*, 219 F.2d 635 (5th Cir., 1955), 55-1 U.S.T.C. 9259, aff'g, 20 T.C. 603 (1953); acq. 1958-2 C.B. 4.

⁶⁰ The substance of those regulations presently is contained in Treas. Reg. sec. 1.61-5.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. Except for tax-exempt farmers' cooperatives, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members.

The availability of these deductions for the cooperative has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with members.

Members of cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative provides items for its members, patronage dividends attributable to purchase of the items are treated as a reduction in the cost of the items to the member.

Cooperatives; exemption of electricity cooperatives from Subchapter T

In general, subchapter T applies to tax-exempt farmers' cooperatives (described in sec. 521(b)) or any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities). However, the 1962 legislation provided that the new rules did not apply to ". . . an organization . . . which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (sec. 1381(a)(2)(C)). Patrons of such a cooperative are taxed under the pre-subchapter T rules discussed above. Thus, such a cooperative can claim a deduction for income that is allocated to their patrons, but the patrons need not include such income in their taxable income.⁶¹

D. Special Energy Tax Incentive Provisions

1. Tax credit for electricity produced by wind, closed-loop biomass, and poultry waste facilities

An income tax credit is allowed for the production of electricity from either qualified wind energy facilities, qualified "closed-loop" biomass facilities, or qualified poultry waste facilities (sec. 45). The credit is allowed for production during the 10-year period after the facility is placed in service. The credit is equal to 1.5 cents per kilowatt hour of electricity produced from qualified sources. The credit amount is indexed for inflation. In 2001, the credit is equal to 1.7 cents per kilowatt hour of electricity produced.

⁶¹ See Rev. Rul. 83-135, 1983-2 C.B. 149.

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before January 1, 2002,⁶² to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, to electricity produced by a qualified poultry waste facility placed in service after December 31, 1999, and before January 1, 2002.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. Poultry waste is poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of poultry manure. In the case of a poultry waste facility owned by governmental unit, the lessee or operator of the facility may claim the credit.

In years in which the Secretary of the Treasury determines that the average annual contract price in the preceding year for electricity sold from facilities using the same qualified resource exceeds eight cents per kilowatt hour, the credit allowable to all eligible taxpayers is reduced. However, for 2001, the Secretary has determined that there is no reduction in the credit by reason of prior year contract prices exceeding eight cents per kilowatt hour.⁶³ The credit allowed also is reduced in the case of any facility that receive grants, tax-exempt finance, subsidized energy financing, or any other credit.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 38(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one taxable year and carried forward 20 taxable years (sec. 39).

⁶² Electricity sold from certain wind facilities is not eligible for the credit notwithstanding that the facility is otherwise a qualifying facility. In general, electricity produced at a qualified facility placed in service after June 30, 1999, but sold pursuant to a contract entered into before January 1, 1987, is not eligible for the section 45 production credit. However, if the taxpayer has entered into certain amendments to pre-1987 sales contracts, the taxpayer may claim the credit for sales under the contract.

⁶³ The Secretary determined that the average annual contract price for electricity from qualified wind facilities was 2.57 cents per kilowatt hour in 2000 and the average annual contract price from qualified closed-loop biomass and poultry waste facilities was zero. Notice 2001-33, 2001-19 I.R.B. 1155.

2. Business energy tax credits for solar and geothermal property

Nonrefundable business energy tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (sec. 48(a)). Solar energy property that qualifies for the credit includes any equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Qualifying geothermal property includes equipment that produces, distributes, or uses energy derived from a geothermal deposit, but, in the case of electricity generated by geothermal power, only up to (but not including) the electrical transmission stage.⁶⁴

Public utility property is not eligible for the business energy tax credits. For this purpose, public utility property is property used predominantly in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, (3) telephone service, telegraph service or other communications service, (4) steam through a local distribution system, or (5) transportation of gas or steam by pipeline, if the rates for furnishing or sale have been approved by a governmental unit, agency, instrumentality, or commission.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 years and carried forward 15 years (sec. 39).

⁶⁴ For purposes of the credit, a geothermal deposit is defined as a domestic geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor, whether or not under pressure (sec. 613(e)(2)).