DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROm: ASSOCIATE CHIEF COUNSEL CC:ITA

SUBJECT:
Inclusion of Supplier Refunds in Income

This Chief Counsel Advice responds to your memorandum dated February 22, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer	=
State A	=
State B	=
State C	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
$X	=
$Y	=
$Z	=

ISSUES

(1) Whether Taxpayer must include in income under the tax benefit rule supplier refunds it receives from pipeline gas suppliers.

(2) Whether assertion of the tax benefit rule would constitute a "new matter" under Tax Court Rule 142, shifting the burden of proof on this issue to the Service.

CONCLUSIONS

(1) Although the tax benefit rule theoretically applies to require Taxpayer to include in income supplier refunds it receives from pipeline gas suppliers, courts have held that taxpayers in similar situations had "no benefit" from such refunds. In this regard, the receipt of funds is not fundamentally inconsistent with the prior deduction, in that Taxpayer is not profiting from the recovery. Accordingly, we do not recommend asserting the tax benefit rule under these facts.

(2) Assertion of the tax benefit rule would constitute a "new matter" under Tax Court Rule 142, shifting the burden of proof on this issue to the Service.

FACTS

Taxpayer is the parent company of an affiliated group that files a consolidated federal income tax return on a calendar year basis and uses the accrual method of accounting. Taxpayer is primarily a natural gas distribution company, but also provides local transportation service. Taxpayer and its related distribution and transmission companies (hereinafter Taxpayer) are subject to regulation by state and federal authorities. Taxpayer is regulated by three state public utility agencies.

Taxpayer purchases its gas supplies and transportation services from interstate pipeline companies, also known as upstream gas suppliers. Taxpayer purchases its gas at rates set by upstream gas suppliers. The gas rates set by the upstream gas suppliers for natural gas and associated transportation are permitted to go into effect within a specified time. However, these gas rates are subject to final review and adjudication by the Federal Energy Regulatory Commission (FERC). Taxpayer charges its customers based on rates originally sought by the upstream gas suppliers, which are sometimes higher than the rates ultimately allowed by FERC. If FERC determines the rates charged by the upstream gas suppliers were excessive, FERC issues an order requiring refunds by the upstream gas suppliers, along with interest. The amount is the difference between the cost of the gas as originally billed and the amount set forth as reasonable by FERC. The FERC administrative order sets forth the date of final settlement and other pertinent information. The supplier refunds are scheduled for disbursement to the utility when final FERC approval is obtained. FERC regulation 18 C.F.R. 154.38. Actual cash payments may be received by a particular local distributor in a different tax period than when the refund was ordered, due to the time required to process the payment.

Taxpayer is required to flow the supplier refunds back to its customers by means of a rate decrement pursuant to the regulatory requirements in place. The three states where Taxpayer operates, States A, B, and C, mandate that the refunds be paid, with interest, by inclusion in the cost of gas adjustment clause. (The applicable interest rate paid to Taxpayer’s customers on the passthrough of the supplier refunds varies by jurisdiction.)

Supplier refunds may be received at any time throughout the taxable year. The provisions for returning supplier refunds to Taxpayer's customers are designed to return the refunds over a twelve-month period. In many cases, the time-lapse between the actual receipt of the refund by the utility and the repayment of the refund to the customer can exceed twelve months. Since the amount of gas delivered by the Taxpayer to its customers in the warm weather is significantly less than in the colder weather, the adjustment clause delivers the refunds back to the Taxpayer's customers much more slowly. Accordingly, under certain circumstances, some supplier refunds are not fully returned to Taxpayer's customers in any significant amount until later than twelve months.

In the tax periods ending December 31, Year 1, Year 2, and Year 3, Taxpayer, pursuant to orders issued by FERC, received refunds from certain upstream gas suppliers in the amounts of $X, $Y, and $Z, respectively.[1] Under Taxpayer's method of accounting, the refunds from the upstream suppliers were not included in income.

The revenue agent contends that the supplier refunds are includible in Taxpayer's gross income under the provisions of I.R.C. §§ 61 and 451 (in the year of the FERC order and not when actually received). The agent also asserts that Taxpayer is entitled to deductions for the amount of the refunds <u>actually paid</u> to the customers pursuant to section 461. Accordingly, the agent proposes to allow Taxpayer deductions for refunds returned to the customers for the tax periods ending December 31, Years 1, 2, and 3. The remaining amount in the supplier refund account was passed on to Taxpayer's customers during the Year 4. Taxpayer contends that the supplier refunds are not includible in its income (thus, no deduction issue).

The notice of deficiency stated, "[i]n accordance with I.R.C. Section 61, it is determined that you have additional gross income from supplier refunds and the interest on those refunds in the amounts and years as follows." The Service's answer does not make any further allegations. Neither the notice nor the answer contain any direct or indirect reference to the tax benefit rule or the direct language of section 111, Recovery of Tax Benefit Items.[2]

In a previous Field Service Advice involving Taxpayer, we concluded that supplier refunds from Taxpayer's upstream suppliers are included in income in the year the refunds are mandated by FERC pursuant to Rev. Rul. 63-182, 1963-2 C.B. 194. We also concluded that supplier refunds passed through to Taxpayer's customers

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[1]The supplier refunds included interest paid on the refunds by the upstream suppliers. The non-interest portion has not yet been broken out.

[2]The inclusionary component of the tax benefit rule is a judicially developed principle and has not been codified; section 111 is the statutory exclusionary component of the rule.

are incurred and taken into account pursuant to the economic performance rules of section 461(h). (Taxpayer may be able to adopt the recurring item exception under Treas. Reg. § 1.461-5.)

[redacted]

You have now asked us to determine whether, as an additional litigating position, the Service could assert the tax benefit rule to include the supplier refunds in income.

LAW AND ANALYSIS

Issue One

The tax benefit rule is a judicially developed principle designed to allay the inflexibilities of the annual accounting system; it is used in situations where strict adherence to an annual accounting system would create transactional inequities. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 377 (1983). Unless a statutory nonrecognition provision applies, the tax benefit rule generally requires the inclusion of income when events occur after an earlier deduction that are fundamentally inconsistent with the deduction. Hillsboro at 372. The subsequent event is one that was unforeseen at the time of the deduction and that would have foreclosed the deduction had it occurred in the same year. Hillsboro at 383-84.

The recovery of a previously deducted bad debt is a classic example of the operation of the tax benefit rule. A taxpayer deducts the amount of a supposedly bad debt from income in one year, thinking the debt is worthless. In a later year, the debt is paid. Repayment of a debt, that is, the recovery of capital, normally is not taxable. Under the tax benefit rule, the subsequent payment is an event fundamentally inconsistent with the prior deduction because it would have foreclosed the deduction had it occurred in the same year. Furthermore, no nonrecognition provisions of the Internal Revenue Code apply to the subsequent payment. Accordingly, the taxpayer must include the subsequent payment in income in the year received, even though it represents a return of capital.

Superficially, the tax benefit rule appears to apply here, since Taxpayer is recovering in a later year amounts that it deducted in a prior year. However, we note that Taxpayer does not appear to receive any benefit from the recovery, in that Taxpayer is required by the regulatory agencies to pass the recovery amount, with interest, on to its customers. As discussed below, a number of courts have held that utilities in similar situations received "no benefit" from the temporary infusion of funds. Furthermore, in that regard, the recovery of funds at issue here does not appear to be fundamentally inconsistent with the prior deduction, in that Taxpayer is not profiting from the recovery; Taxpayer is required to refund the recovery to its customers with interest. By contrast, in the recovery of debt example cited above, the creditor keeps the subsequent and unforeseen repayment of the previously deducted bad debt.

We note, however, some authority for requiring recognition of the income under the tax benefit rule. First Trust and Savings Bank of Taylorville v. United States, 614 F.2d 1142 (7th Cir. 1980). In First Trust, a bank paid personal property taxes on behalf of its shareholders and deducted the payments from its income in 1972. As a result of litigation that ultimately went to the United States Supreme Court, the taxes were refunded to the bank in 1973. Even though the bank was required eventually to refund the taxes to the shareholders on whose behalf they were collected, the Seventh Circuit held that the bank’s recovery of the taxes was income under the tax benefit rule. A critical element of the court's ruling, however, was the fact that the refunds distributed to the shareholders were corporate dividends that should not have been deductible by the bank. "Thus, unless the deduction previously taken is reversed (by taxing the amount of the refund), the Bank will, in effect, have benefited from a deduction taken for a nondeductible distribution." 614 F.2d at 1147.

Furthermore, First Trust did not involve a regularly recurring situation; indeed, the situation arose as the result of an amendment to the Illinois state constitution. By contrast, regulated utilities such as Taxpayer regularly receive amounts that are ultimately required to be refunded to their customers. Attempts to characterize these receipts as income have met with limited success. For instance, the Supreme Court held that customer deposits that a utility was ultimately required to return to the customers were not income to the utility. Commissioner v. Indianapolis Power & Light Co.,493 U.S. 203 (1990).

Similarly, in Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), a regulatory agency ordered a utility to increase rates to commercial customers to encourage conservation. Although the agency made it clear that the utility would not be allowed to keep the excess revenue, it did not require segregation of the funds. Eventually, several years later, the utility was required to disburse the excess in the form of credits to its customers. The Service contended that the excess revenues were income to the utility in the year received. The Seventh Circuit disagreed, holding that the revenues were not taxable income because the utility could "derive no benefit at all from having held the money." 792 F.2d at 690.

The same result obtained in Houston Industries, Inc. v. United States. There, the Federal Circuit held that a utility's fuel cost overrecoveries were not taxable income where the utility had a statutory obligation to refund the funds to customers, with interest, by refunds or offsetting underrecoveries. The overrecoveries represented the amounts by which an estimated fuel cost component on customers' bills exceeded subsequently determined actual fuel costs. The Federal Circuit relied on Indianapolis Power & Light and Illinois Power to conclude that the overrecoveries were not income. 125 F.3d at 1444-1445. In so ruling, the court noted that the utility "derived no benefit from retaining the overpayments."[3]

Furthermore, we would expect the Tax Court to reject any attempt by the government to distinguish these cases from Taxpayer's case on the theory that the prior cases did not involve refunds to the utilities from upstream suppliers. In a recent case, the Tax Court held that a utility's overcollections from customers for fuel and energy conservation costs were not income to the utilities, where the overcollections were subject to an unconditional obligation to refund them to the customers. Florida Progress Corp. v. Commissioner, 114 T.C. 587 (2000). In so ruling, the court noted that the utility was required to pay interest on its overcollections, was "burdened by additional accounting and administrative responsibilities," and derived "no benefit" from the regulatory imposed recovery system.

Florida Progress is all but precisely on point, in that the facts are almost identical to Taxpayer's. Furthermore, the Tax Court specifically rejected the government's argument that Indianapolis Power should be construed narrowly. 114 T.C. at 600. Thus, it is all but certain that the Tax Court would apply Indianapolis Power & Light to Taxpayer's case. Furthermore, while Illinois Power, Houston Industries, and Florida Progress did not address the tax benefit rule, in all three cases the courts concluded that the utility received "no benefit" from the amounts it collected and eventually refunded to its customers. Thus, while the tax benefit rule may theoretically apply in Taxpayer's case, we believe it would be difficult to argue that Taxpayer received a tax benefit in a situation where courts have ruled that similarly situated taxpayers received no benefit. In this regard the receipt of funds is not fundamentally inconsistent with the prior deduction, in that Taxpayer is not profiting from the recovery, and we therefore do not recommend asserting the tax benefit rule under these facts.

Issue Two

Generally, the burden of proof is on the taxpayer. Welch v. Helvering, 290 U.S. 111 (1933); Tax Court Rule 142(a). However, except as otherwise provided by

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[3]The court also concluded that system "burdened" the utility with "additional accounting and administrative responsibilities." Id. at 1445.

statute or determined by the Tax Court, where a new matter is presented, the burden of proof with regard to the new matter is placed upon the Service. Tax Court Rule 142(a).

A "new matter" requiring a shift of the burden of proof is distinct from a new legal theory that clarifies or develops the original determination listed in the notice of deficiency without requiring the production of additional evidence or increasing the amount of the deficiency. Achiro v. Commissioner, 77 T.C. 881, 890 (1981). Rather, a new matter alters the deficiency or requires the presentation of new factual issues or rationales. 77 T.C. at 890. Where the notice of deficiency is stated in general terms, and can be sustained on several different theories, the burden remains on the taxpayer as long as the Service relies on a theory or theories consistent with the notice of deficiency. Renner v. Commissioner, T.C. Memo. 1994-263, citing Zmuda v. Commissioner, 79 T.C. 714, 722 n.19 (1982), affd. 731 F.2d 1417 (9th Cir. 1984). However, the Tax Court has been reluctant to accept any overly general language of the explanation of adjustments within the notice of deficiency as "sufficiently broad to encompass [new] theories," requiring wording which more directly identifies each of the new theories, particularly where the taxpayer has been led to believe that the Service is limiting its arguments to one or more specific legal theories. See Shea v. Commissioner, 112 T.C. 183 (1999); Achiro, 77 T.C. at 881; Renner, T.C. Memo. 1994-263.

Here, while the ultimate result of asserting the tax benefit rule would be to increase the deficiency to include additional gross income from supplier refunds, such general language in the notice could be the result of many theories of liability. As such, the Tax Court may consider the language in the notice too broad to have notified Taxpayer that the tax benefit theory would be asserted.

Other factors also suggest that the tax benefit theory is a new matter for which the burden of proof should be shifted to the Service. For example, neither the notice nor the answer contains a direct or indirect reference to the tax benefit rule or the language of section 111. There is no evidence that Taxpayer was otherwise alerted to the fact that by the broad wording of the notice, the Service intended to argue the tax benefit theory. Shea appears to consider notice to the taxpayer irrelevant to an analysis of whether an issue is a "new matter." In any case, it appears that only Service attorneys were aware of the tax benefit argument. See Renner, T.C. Memo. 1994-263. Taxpayer will need to present additional facts and evidence to defend against the tax benefit theory, which it may not have anticipated. Also, it appears that to in order to argue the tax benefit theory, the Service will need to clarify several facts regarding the timing and amount of adjustments, which are apparently not necessary for other arguments in the case.

In light of the Tax Court's reluctance to allow general wording in the notice to cover more specific matters and the need for both parties to present additional facts and theories, it appears that the Service's only course of action would be to amend the answer and proceed under the assumption that it must carry the burden of proof on the new matter.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

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