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

OFFICE OF
CHIEF COUNSEL

May 12, 2000

Number: **200034003**
Release Date: 8/25/2000
CC:DOM:FS:IT&A
TL-N-902-99
UILC: 61.29-00, 461.18-07

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Inclusion of Supplier Refunds into Income/Year of Deduction for Supplier Refunds

This Field Service Advice responds to your memorandum dated February 14, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

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

ISSUES

1. Whether supplier refunds received by Taxpayer, primarily a natural gas distribution utility, from its upstream suppliers is income in the year the refunds

were mandated by order of the Federal Energy Regulatory Commission (FERC) or whether such refunds can be excluded from income because the amounts of the refund must be passed on to Taxpayer's customers.

2. If the supplier refunds are includible in income, in what year can Taxpayer take into account deductions associated with the refunds passed on to its customers.

CONCLUSIONS

1. 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.

2. Supplier refunds passed through to Taxpayer's customers are incurred and taken into account pursuant to the economic performance rules of I.R.C. § 461(h). Taxpayer may be able to adopt the recurring item exception under Treas. Reg. § 1.461-5.

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 utility, 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 purchased its gas supplies and transportation services from interstate pipeline companies, also known as upstream gas suppliers. Taxpayer purchases its gas at rates set by the 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 FERC. Taxpayer charges its customers based upon the rates originally sought by the upstream gas suppliers which are sometimes higher than the rates ultimately allowed by FERC. In the event that FERC determines the rates charged by the upstream gas suppliers were excessive, an order is issued by FERC requiring refunds to be made 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.

Since Taxpayer is only allowed to recover its actual gas costs, it is required to flow the supplier refunds back to its customers by means of a rate decrement pursuant to the regulatory requirements in place. States A, B, and C, the three states where Taxpayer operates, mandate that the refunds, with interest, be returned by inclusion in the calculation of 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 customer at a much lower rate. Accordingly, some supplier refunds are not fully returned to Taxpayers's customers in any significant amount until later than 12 months.

In the tax periods ending December 31, Year 1, 2, and 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 the taxpayer's method of accounting, these refunds from the upstream gas suppliers were not reported in gross income.

The revenue agent contends that the supplier refunds are includible in the gross income of the taxpayer utility under the provisions of sections 61 and 451 (in the year of the FERC order and not when actually received). The agent also asserts that the taxpayer is entitled to deductions for the amount of the refunds <u>actually paid</u> to the customers pursuant to I.R.C. § 461. Accordingly, the agent proposes to allow the 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 the taxpayer's customers during the Year 4. The taxpayer contends that the supplier refunds are not includible in its income (thus, no deduction issue).

---

[1] These supplier refund amounts also include the interest paid on the refunds by the upstream suppliers. The non-interest portion has not been broken out at this time.

LAW AND ANALYSIS

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 61(a) provides in general that, except as otherwise provided by law, gross income means all income from whatever source derived, including (but not limited to) gross income derived from business.

Treas. Reg. § 1.61-3(a) generally provides that in a manufacturing, merchandising, or mining business, “gross income” means total sales, less cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

Section 451(a) provides that, as a general rule, the amount of any item of income shall be included in gross income for the taxable year in which it is received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Treas. Reg. § 1.451-1(a) provides, in part, that under the accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 162(a) provides a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing income.

Section 461(h) and Treas. Reg. § 1.461-1(a)(2)(i) provide that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the liability, (2) the amount of the liability can be determined with reasonable accuracy, and
(3) economic performance has occurred with respect to the liability.

Treas. Reg. § 1.461-4(g)(3) provides in part that if a taxpayer’s liability is to pay a rebate, refund, or similar payment to another person, then economic performance occurs as payment is made to the person to whom the liability is owed.

Treas. Reg. § 1.461-5(a) permits a taxpayer to adopt the recurring item exception as a method of accounting for one or more types of recurring items incurred by the taxpayer. The recurring item exception permits a taxpayer to treat a liability as incurred for a taxable year if the all events test is met in that year; economic performance is met with the period of filing the return for that year or within eight and one-half months after that taxable year; the liability is recurring; and either the amount is not material or there would be better matching with the income than would result from accruing the liability for the taxable year in which economic performance occurs. Treas. Reg. § 1.461-5(b). Treas. Reg. § 1.461-5(d) permits a taxpayer to adopt the recurring time exception as part of its method of accounting for any type of item for the first taxable year in which that type of time is incurred.

Section 446(b), which is an exception to the general rule of section 446(a), provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. Hamilton Industries v. Commissioner, 97 T.C. 120 (1991). Whether a particular method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis. Peninsula Steel Products & Equipment Co. v. Commissioner, 78 T.C. 1029, 1045 (1982).

Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that a taxpayer which changes its method of accounting on the basis of which it keeps its books must, prior to changing to a different method, secure the consent of the Commissioner. Consent must be secured regardless of whether the method a taxpayer is changing is proper or permitted. Treas. Reg. § 1.446-1(e)(2)(2)(i); Commissioner v. O Liquidating Corp., 229 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961).

Rev. Rul. 63-182, 1963-2 C.B. 194, involves an upstream supplier refund to a taxpayer utility. After the supplier refund to the taxpayer utility was ordered, the taxpayer in turn had to pass on the supplier refund and interest to its customers. The revenue ruling holds that the taxpayer utility has income in the year the supplier refund order was final and that the utility's obligation to its customers is a deductible business expense. The taxpayer utility's liability was established on the date of the order approving the rate settlement agreement and not over the 12-month period that the utility actually adjusted its customers' bills.

Similarly, Rev. Rul. 72-28, 1972-1 C.B. 269, involves a situation where a public utility received supplier refunds which it included in income and also took corresponding deductions for amounts passed on to the utility's customers. The revenue ruling concludes that section 1341 applies to supplier refunds that a public utility passed through to its customers, reasoning that the utility had a binding obligation to do so. Section 1341(b)(2) generally provides that section 1341 is inapplicable to restorations attributable to sales of inventory. However, section 1341(b)(2) specifically excepts refunds or repayments with respect to rates made by a regulated public utility if the utility is required to made them by the government, a court order, a settlement agreement, or under threat or imminence of litigation. Rev. Rul. 72-28 concludes that this requirement was met because utility's customers could have commenced litigation under their contractual arrangements to enforce the passing through of the refunds.

Taxpayer contends that Rev. Rul. 63-182 is inapplicable because it was enacted prior to the economic performance rules of section 461, which presently apply. The taxpayer asserts that the revenue ruling was never challenged since it allowed for an immediate deduction on the accrued liability to ultimate customers.

Furthermore, there is an apparent conflict between Rev. Rul. 63-182 and Rev. Rul. 72-28 on the one hand, and Rev. Rul. 80-308, 1980-2 C.B. 162, and some court cases on the other hand. Rev. Rul. 63-182 holds that a utility' obligation to reduce future rates to pass through refunds received from a supplier is a liability, deductible from gross income under section 162. Rev. Rul. 72-28 applies section 1341 in a situation similar to that in Rev. Rul. 63-182. Rev. Rul. 80-308 holds that a utility's subsequent fuel rate increase to compensate for an earlier undercharge (underrecovery) is an adjustment to future sales (as oppose to a deduction). Similarly, the Service has successfully argued in litigation that negative fuel adjustments to remedy earlier overcharges are not deductible, but rather are reduction in future sales. Roanoke Gas Co. v. United States, 977 F.2d 131 (4th Cir. 1992); Southwestern Energy Co. v. Commissioner, 100 T.C. 500 (1993).

Service position is reflected in revenue rulings. For supplier refunds, Service position is established in Rev. Rul. 63-182 and Rev. Rul. 72-28. Income is recognized when the supplier refunded is ordered; likewise, a deduction is permitted for the amounts passed through to the customers. Rev. Rul. 80-308 and the cases involve fuel rate adjustments and not supplier refunds. For fuel rate adjustments, there is no deduction permitted nor is income recognized. Instead, adjustments are made to future sales.

In this situation, in the tax periods ending December 31, Year 1, 2, and 3, Taxpayer, pursuant to orders issued by FERC, received refunds from certain upstream gas suppliers in the amounts of $X, $Y and $Z, respectively.[2] Under the taxpayer's treatment, these refunds from the upstream gas suppliers were not reported in gross income. This is contrary to Service position, which holds that supplier refunds must be included in income, under section 61 and section 451. See Rev. Rul. 63-182, Rev. Rul. 72-28. Rev. Rul. 63-182 concludes that supplier refunds received by a utility from upstream suppliers is income to the utility in the year the order is entered by the federal regulatory body. The language in section 61 is to be interpreted broadly, so that any funds received by a taxpayer are presumed to be income unless the taxpayer can establish that the funds fit within a specific exclusion in the Internal Revenue Code. Iowa Southern Utilities Co. v. United States, 841 F. 2d 1108, 1111 (Fed. Cir. 1988); James v. United States, 366 U.S. 218, 219 (1961); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-31 (1955). Although an argument can also be made that the income should be included under the tax benefit rule, because we rely on Service position as expressed in the revenue rulings, we concluded the supplier refunds are income in the year the FERC order is final.

Because Taxpayer must include the supplier refunds into income pursuant to Service position as expressed in Rev. Rul. 63-182, Taxpayer is entitled to a deduction for the amounts passed through to its customers. Taxpayer may take a deduction for its customer rebates consistent with the economic performance rules of section 461(h). In the legislative history to section 461(h), Congress acknowledged Rev. Rul. 63-182 and specifically stated its intention for Treasury to preserve the holding “in the case of natural gas supplier refunds.” H.R. Conf. Rep. No. 98-861, 98th Cong. , 2d Sess. 875-76 (1984), 1984-3 C.B. (Vol. 2) 129-30. The preamble to the final regulations under section 461(h) economic performance rules notes that commentators argued that, in the case of supplier refunds which are then passed on as customer refunds, economic performance should not be delayed until payment. T.D. 8408, 1990-1 C.B. 155, 160. However, this was not the approach adopted by the Service. Treas. Reg. § 1.461-4(g)(3) provides a payment rule for refund liabilities, applying to refunds or transfers in the nature of a rebate or refund. In explaining why the regulations under section 461 do not contain the rule requested by the commentators, the preamble seems to assume that a special rule is not necessary because all utility refunds are covered by the recurring item exception:

> ... the recurring item exception provides relief to all public utilities where refunds are paid within a reasonable period following receipt of the related income. The service and

---

[2] These supplier refund amounts also include the interest paid on the refunds by the upstream suppliers. The non-interest portion has not been broken out at this time.

> the Treasury Department believe the recurring item exception carries out the legislative intent with respect to public utility rebates without crating inequities in the treatment of other rebates.

T.D. 8408, 1990-1 C.B. 155, 160.

Accordingly, Taxpayer under the economic performance rules can only take into account and deduct its liability for customer refunds in the year paid, even though that may be a later and different year from the year the supplier refunds were includible in income. However, if Taxpayer can elect the recurring item exception, it may deduct in the earlier year those customer refunds passed through by eight and a half months into its next tax year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted] There is precedent in case law to exclude fuel cost overrecovery from gross income in the year received if the utility is under a binding obligation to return the overrecovery to its customers. Houston Industries, Inc. v. United States, 32 Fed. Cl. 202 (1994), aff'd, 78 F.3d 564 (Fed. Cir. 1995). See also Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986). While fuel cost overrecovery (or underrecovery) are distinct from supplier refunds, as reflected in Service position and the views of the Chief Counsel, a court could view supplier refunds as akin to deposits and agree that Taxpayer's treatment of exclusion of income and no deduction is proper.

While your incoming memorandum does not address this issue, we believe that when Examination requires the inclusion and the deduction of the supplier refunds, Examination should permit Taxpayer to adopt the recurring item exception under Treas. Reg. § 1.461-5. Such an approach is consistent with the legislative history to section 461(h) and the preamble to the final regulations. Additionally, this would come close to the position expressed in Rev. Rul. 63-182, providing (almost) a "wash" for Taxpayer of the supplier refund gross income and the pass through to the customers. Because the facts indicate that the refunds may take over a year, in some cases, before they are paid to the customers in a rebate, there will some amounts which do not wash. However, the bulk of income and deductions should offset, if Taxpayer is permitted to adopt the recurring item exception in Year 1 for its treatment of the customer refunds.

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel (Field Service)

By: ______________________
GERALD M. HORAN
Senior Technician Reviewer
Income Tax & Accounting Branch