Mailed

JUL 12 1988

ALJ/KT/jt *

ORIGINAL

Decision 88 07 020 JUL 8 1988

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the methods to be utilized by the Commission to establish the proper level of expense for ratemaking purposes for public utilities and other regulated entities due to the changes resulting from the 1986 Tax Reform Act.	I.86-11-019 (Filed November 14, 1986)

ORDER ON PETITION FOR MODIFICATION OF DECISION 87-09-026 OF THE CITY OF MOUNTAIN VIEW

On February 2, 1988, the City of Mountain View (Mountain View) filed its Petition for Modification of Decision (D.) 87-09-026, dated September 10, 1987. Mountain View requests that D.87-09-026 be modified to reflect Internal Revenue Service (IRS) Notice 87-82, IRS Bulletin No. 1987-51 (December 21, 1987) (Notice). Mountain View contends that the Notice confirms that contributions paid to public utilities by governmental entities for relocating or undergrounding utility facilities or in connection with threatened condemnation should not be considered to be taxable under Section 824 of the Tax Reform Act of 1986, Public Law No. 99-514 (TRA-86).[1]

Mountain View requests that D.87-09-026 be modified so that:

(a) Utilities be permanently barred from charging a gross-up on payments by a governmental entity to a public utility where the payment "does not reasonably

1 Before TRA-86 such contributions paid in money or in kind to a public utility were considered a contribution to the utility's capital. Under TRA-86 they are treated as gross income of the utility subject to taxation.

relate to the provisions of services by [the] utility...but rather relates to the benefit of the public at large." (Notice at 11.)

(b) Bar any gross-up of payments made by governmental entities that meet the criteria of Section 1031 or 1033 of the Internal Revenue Code (I.R.C.).

(c) Utilities no longer be permitted to require "written assurance that the risk of contrary IRS ruling will be borne by the government agency..." regarding these sorts of payments. The risk of "contrary IRS ruling" has been eliminated by the Notice for these types of payments by governmental entities.

Mountain View requests that the Commission not modify D.87-09-026 regarding contributions for extending service to new governmental projects, since it does not agree with the IRS findings. Payments for extensions to new public buildings should continue to be collected by the utilities net of tax for two years from the issuance of D.87-09-026, provided that governmental entities provide adequate written assurance that they will pay any tax the IRS ultimately determines to be due. This will allow time for the municipalities to obtain regulatory or legislative relief from the IRS's adverse determination regarding payments for line extensions.

The State of California by and through the Department of Transportation (CalTrans) also filed a petition requesting modifications similar to Mountain View's and also in support of Mountain View's Petition for Modification of D.87-06-026 with respect to forbidding any gross-up of payments made by governmental entities that meet the criteria of Section 1031 or 1033 of the I.R.C. Since CalTrans' petition is similar to Mountain View's petition, it will not be repeated.

Responses to Petitions for Modification

Responses to the Petitions for Modification were filed by Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCal), and San Diego Gas & Electric Company (SDG&E). In addition, SDG&E filed an alternative Petition for Modification of D.87-09-026 designed to address changes it feels are necessary to reflect the impacts of the Notice. Specifically, with the issuance of the Notice, SDG&E believes D.87-09-026's reference to obtaining a revenue ruling by September 9, 1989 should be expunged. SDG&E also believes the Commission should eliminate the "written assurances" requirement which was to be used only until an IRS Ruling was issued. SDG&E further believes the Commission should modify the decision to instruct utilities not to gross-up for taxes where the transaction is clearly not taxable, to gross-up for taxes where the transaction is clearly taxable, and to gross-up for taxes when the utility reasonably believes uncertainty exists regarding whether or not the transaction is taxable.

While the utilities were generally in agreement in their responses to the Petitions for Modification, there were several areas in which their recommendations differed. In those situations the utilities will be identified by company names.

Responding utilities are in general agreement that the Notice clarifies the nontaxable nature of governmental payments for many relocations including highway relocation and most government-sponsored undergroundings. Moreover, the utilities are in agreement that the Notice is not as broad-sweeping as Mountain View suggests, since it includes conditional language which clearly limits the extent of potential exclusion. Based upon the conditional language included in the Notice, utilities believe that relocations and undergroundings performed in connection with a development requiring new utility services may still be taxable, even though payments for such relocation and undergrounding work are made by a governmental agency.

Responding utilities further agree that transactions qualifying under Sections 1031 and 1033 of the I.R.C. should be treated under those provisions and not as a taxable contribution. However, the utilities note that for this exemption to apply, there must first be a determination that the transaction qualifies under these Code provisions.

Finally, responding utilities agree that the Notice clarifies the taxability of payments by governmental agencies for line extensions providing new services. This is the case whether or not the utility service is for the public benefit.

Proposals to Implement the Notice

A. Nontaxable Situations

In circumstances involving relocations and undergroundings which are clearly nontaxable under the Notice as well as transactions clearly qualifying under I.R.C. Section 1031 or 1033, PG&E will require neither a "gross-up" nor a written "contract to pay." Such circumstances include most, if not all, state highway relocation work as well as nearly all undergroundings of existing utility lines paid for by special assessment districts or out of general governmental funds. When the transaction is clearly nontaxable, there is no disagreement among the three utilities filing responses as to the appropriateness of this approach.

B. Taxability Uncertain

While the Notice clarifies that governmental payments for many relocations are nontaxable, it identifies some factual circumstances in which relocations would be treated as CIACs and included in gross income, if such payments relate to the provision of service by the utility. Because the Notice does not address every factual scenario that may arise, there will be situations where reasonable persons may differ on the taxability issue. However, the Notice itself is very clear that relocations relating

to the provision of service will be treated as CIACs under TRA-86, and included in gross income.

In circumstances where relocations or undergroundings appear to be exempt from tax under the Notice but where some doubt exists, PG&E proposes to require a new, less onerous form of "written assurance" from a governmental agency. Such form will not require that the government agency receive a "favorable IRS determination" by September 9, 1989, but will merely cover the situation where there is an unexpected, adverse IRS determination. Under PG&E's proposal the government agency would be released from its "written assurance", if it could obtain a favorable IRS ruling. In those circumstances where PG&E continues to have reasonable doubt regarding the nontaxability of a governmental transaction, PG&E would request that the governmental agency receive a favorable IRS determination within a reasonable period. PG&E would collect the gross-up only if such a favorable determination could not be obtained. SoCal's position is similar to PG&E's.

SDG&E's position differs from the other two utilities in situations where the taxability of the governmental transaction is uncertain and the utility believes a reasonable risk of taxability exists. In that situation SDG&E believes the utility should be permitted to gross-up for taxes. SDG&E's reasons for allowing gross-up are:

1. Written assurances are an interim measure to be utilized only until the IRS issues a Notice of Revenue Ruling. Such notice has been issued.

2. Continuing to accept written assurances when there is a reasonable risk that the transaction is taxable is inconsistent with the decision's finding that the best

procedure to reduce ratepayer risk[2] and protect the utility is to require the utilities to collect the tax gross-up on all contributions (D. at 67).[3]

3. Grossing-up governmental contributions when the utility believes there is a reasonable risk of taxability is consistent with prudent tax collection practices. Vendors collect all pertinent taxes unless the vendee can prove the transaction is tax exempt. Any other practice puts the vendor (utility company) at risk for payment of tax.

4. It would be impractical, costly, and overly burdensome for SDG&E to accept written assurances pending further IRS direction. The only likely additional IRS direction is "Private Letter Rulings" because the IRS has already issued a generic Revenue Ruling ("Notice"). Private letter rulings are fact specific and not binding even when identical facts exist in another transaction. Each transaction requires a separate private letter ruling proceeding. Each year SDG&E engages in hundreds of

---

2 SDG&E and PG&E disagree regarding the acceptance of written assurances when taxability of the transaction is uncertain. The reason may be because PG&E has chosen Method Five and SDG&E the Maryland Method. The Maryland Method places the risk of not collecting the amounts secured by the written assurances on the utilities' shareholders; Method Five places this risk on the ratepayers.

3 A written assurance gives SDG&E nothing more than a right-to-sue. Given the costs of litigation and the technical nuances of governmental budgeting which can defeat a valid claim for money, a right-to-sue to collect tax dollars may not be worth the paper on which the "written assurances" are written.

If other utilities are willing to accept written assurances in lieu of grossing-up contributions for taxes, they should be permitted to do so. However, no utility should be allowed to pass on to ratepayers any costs or losses associated with accepting written assurances.

projects involving governmental entities where the taxability of the transaction may be at issue. Because the decision presently requires utilities that receive written assurances to "cooperate" with the governmental entities attempting to obtain an IRS ruling that their transactions are not taxable (D. 74, Finding of Fact 9), SDG&E could ultimately be involved in hundreds of private letter ruling proceedings. To handle the additional work associated with these proceedings would require adding or contracting for personnel at ratepayer expense. This result is inconsistent with the decision's conclusion that contributors should bear the costs associated with their contributions, not the ratepayers.

C. Clearly Taxable Situations

Utilities agree that governmental transactions which are clearly taxable pursuant to the Notice should be grossed-up for taxes. Utilities state that it makes no sense to require written assurance against an adverse IRS determination when such IRS adverse determination already exists. Since the IRS has determined that service extension situations are taxable transactions, the utilities must now pay the taxes due on such transactions. Utilities are unanimous in their opposition to Mountain View's request that a gross-up not be applied in service extension situations, simply because Mountain View does not agree with the IRS ruling.

Subsequent Filings

On May 9, 1988 the California Department of General Services (DGS) filed comments addressing Mountain View's Petition, requesting that the Commission delay deciding this matter at its regularly scheduled meeting of May 11, 1988, in order to consider the substance of DGS' comments. DGS believes that we should grant Mountain View's Petition and keep the two-year window open (i.e. continue to require utilities to accept written assurance in

situations that may still be treated as taxable to the utility in light of the Notice). DGS argues that a partial victory by the governmental entities should not be treated as a defeat in other situations, as the responding utilities implicitly urge. Additionally, DGS believes that more favorable tax treatment is likely in the future, given Congressman Matsui's introduction of legislation (HR 3250) which would reverse the decision to treat contributions as gross income for all contributors, not just governmental entities. DGS states that HR 3250 has support from a variety of interests, making "particularly untimely" a modification of D.87-09-026 to allow the collection of gross-up rather than provision of written assurances.

Alternatively, DGS suggests that we take no action on Mountain View's Petition at this time, since passage of HR 3250 would likely result in modification of D.87-09-026 with respect to all utility customers, not just governmental entities.

On May 31, 1988 SDG&E filed a Response opposing DGS' requests for delay in implementation of the IRS Ruling. SDG&E asserts that even if successful, HR 3250 would be effective no earlier than January 1, 1989, meaning that 1987 and 1988 transactions will still be taxed in accordance with the IRS Ruling. Further, there are no guarantees that HR 3250 will pass.

SDG&E urges us to implement the Ruling by identifying, consistent with that Ruling, when gross-up for taxes is permissible and when it is not; and authorizing collection of gross-ups when appropriate.

On a related front, on May 19, 1988, Mountain View filed a Motion to Convene Workshops, citing the fact that the utilities responding to its Petition have expressed differing views, and the introduction of HR 3250, as noted in DGS' comments. Mountain View believes that a workshop may be a useful approach for resolving the various differences among the parties. In a formal response filed June 20, 1988 SDG&E opposes a workshop as premature,

given the pendency of its alternative Petition; it also believes that the Commission's order in this matter can and should resolve the very issues to be discussed in the workshop.

Discussion

As the DGS' comments and the related subsequent filings demonstrate, the issue we face is whether (and how) to implement the IRS Ruling, or alternatively whether to preserve the status quo while the Congress considers HR 3250. The Mountain View Petition presents a variation on this theme, urging partial implementation of the IRS Ruling, where positive to the governmental entities' interests, and retention of the status quo (the two-year window) in areas where the Ruling is adverse to those interests so that legislative or regulatory alternatives can be explored.

This decision rejects both delay and partial implementation in favor of full implementation. In doing so, we accept SDG&E's argument that workshops, designed to resolve the parties' differences, are unnecessary. The issues Mountain View proposes to discuss at such workshops are the very issues it earlier presented to us in its Petition; we believe these issues have been thoroughly briefed by the various parties and are ripe for decision. Further, there is no reason to delay implementation to permit the Ruling to be challenged on the legislative and regulatory fronts, where such delay unnecessarily exposes ratepayers to further risk in an area settled by the IRS.

Although Mountain View's and CalTrans' (Petitioners) requests for Modification of D.87-09-026 have been opposed by the utilities, the difference in positions taken by the parties are not as great as it appears. Utilities agree that they should not require any gross-up or written contract to pay for relocations and undergroundings which are clearly nontaxable under the Notice, as well as transactions clearly qualifying under I.R.C. Section 1031 or 1033. This includes most, if not all, state highway relocation work as well as nearly all undergroundings of existing utility

lines paid for by special assessment districts or out of general governmental funds. Thus, the treatment of this type of governmental contributions is noncontroversial.

There is similarly agreement between petitioners and the utilities that certain transactions, namely service extension situations, are clearly taxable under the Notice. Utilities agree that such contributions should now be grossed-up and paid by the governmental agencies since the IRS has now come forth with its adverse determination by making such transactions taxable to the utilities. Mountain View, however, requests that D.87-09-026 not be modified to permit utilities to gross-up such transactions in order to enable the municipalities to obtain regulatory or legislative relief from IRS's adverse determination. By not modifying D.87-09-026, the municipalities would have until September 9, 1989 before the utilities would be able to collect on the tax gross-up of such contributions. The question at issue is whether in view of the negative IRS ruling in the Notice regarding service extension situations, should utilities be prevented from collecting such tax gross-up until September 9, 1989 in order to permit the municipalities an opportunity to obtain a favorable IRS determination? Since our primary goal in this matter is to protect the ratepayers from any undue risks, we believe the utilities should now be permitted to collect such tax gross-up without any further delay.

Finally, we will address the more controversial situation where there is some doubt as to the taxability or nontaxability of the contributions. First, we concur that where there is any doubt as to the taxability of a contribution the utilities should be allowed to make a determination as to the form of security necessary to ensure that such amounts will be paid, if the ultimate resolution is that such transactions are taxable. We will leave it up to the utility to determine whether it should use PG&E's approach of a written assurance with no collection of the gross-up

for taxes until a specified period of time has elapsed, or SDG&E's proposal to collect the tax gross-up subject to refund including interest should a favorable ruling be obtained, or a combination of the two methods. However, we share SDG&E's concerns about the adequacy of written assurances, and no utility will be allowed to pass on to ratepayers any costs or losses associated with accepting written assurances. This will provide equal protection for ratepayers and shareholders, no matter which method of accounting for CIAC a utility may choose.

Therefore, **IT IS ORDERED** that D.87-09-026, as modified by D.87-12-028, is further modified as follows:

1. Additional Finding of Fact 10 is added to read:

   "Official notice is taken of Internal Revenue Service Notice 87-82, published in IRS Bulletin No. 1987-51, December 21, 1987, which provides guidance with respect to treatment of contributions in aid of construction after enactment of Section 824 of the Tax Reform Act of 1986, Public Law No. 99-514."

2. Additional Finding of Fact 11 is added to read:

   "Under IRS Notice 87-82 there is general agreement that payments made by governmental entities which are a prerequisite to the provision of services by the utility are taxable even though such facilities are conducted for the benefit of the community at large."

3. Additional Finding of Fact 12 is added to read:

   "There is general agreement that under IRS Notice 87-82 relocation payments received by utilities under a government program for placing utility lines underground or for the cost of relocating utility lines to accommodate the construction or expansion of a highway and not for the provision of service shall not be treated as a contribution in aid of construction and thus are clearly nontaxable. Utilities shall not require "written

assurances" where the transaction is clearly nontaxable."

4. Additional Finding of Fact 13 is added to read:

"Mountain View disagrees with the Notice that payments for extensions to new public buildings are taxable. Mountain View requests that these payments be continued to be collected net of tax for two years from the issuance of D.87-09-026 to enable the municipalities to obtain regulatory or legislative relief from the IRS's adverse determination regarding payments for line extensions."

5. Additional Finding of Fact 14 is added to read:

"While the Notice clarifies the taxability or nontaxability of certain contributions, there is still a grey area that needs further resolution involving undergrounding or relocation and the provision of service."

6. Modify Finding of Fact 9 to read as follows:

"Although no methods were introduced during the hearings that showed by clear and convincing evidence that the IRS would not impose a tax on a particular transaction, except that contributions resulting from condemnation or the threat or imminence thereof or which are for a public benefit appear to be exempt from tax, IRS Notice 87-82 has clarified the taxability or nontaxability of certain contributions from governmental agencies although some uncertainty still remains regarding the tax treatment of certain types of relocations and undergroundings. Where there is still uncertainty as to whether a tax risk remains, we will allow the utilities to make a determination as to whether they will require the payment of the tax gross-up or be satisfied with a written assurance against adverse IRS determination to be obtained within a time span designated by the utility before the tax gross-up must be paid subject to refund should a favorable ruling be obtained. We caution the utilities that whatever choice they make, the ratepayer may not be charged with back taxes, penalties, or interest."

Conclusions of Law

1. Modify Conclusion of Law 2 to read as follows:

"All contributions and refundable advances should be assumed to be subject to federal income tax until the IRS rules otherwise, except that contributions by governmental agencies which result from condemnation or the threat or imminence of condemnation, or for relocating utility facilities or undergrounding under a government program and does not reasonably relate to the provision of service should not be considered taxable. If the utility believes that there is a risk of taxability of a transaction, it may request adequate written assurance (a contractual promise to pay) from the governmental agency that the risk of a contrary IRS ruling will be borne by the governmental agency or in the alternative require the payment of the tax gross-up. If a favorable IRS determination applicable to a particular type of government agency contribution is not received within a time frame specified by the utility, such transaction is presumed taxable and subject to gross-up until a favorable IRS determination is received. In the case where the gross-up is paid and a favorable determination is subsequently received, such payment is subject to refund plus applicable interest."

2. Add Conclusion of Law 20 to read:

"IRS Notice 87-82 has clarified the taxability or nontaxability of contributions made by governmental agencies for typical highway relocation or undergroundings and for extensions for new services; however, it leaves uncertain the taxability of certain other relocation and undergrounding work even though payments are made by a governmental agency."

3. Add Conclusion of Law 21 to read:

"Utilities should not require written assurance nor collect for tax gross-up where the transaction is clearly nontaxable."

4. Add Conclusion of Law 22 to read:

"Utilities should collect for tax gross-up where the transaction is clearly taxable even though the governmental agency making the contribution may disagree with IRS Notice 87-82."

5. Add Conclusion of Law 23 to read:

"Where the taxability of a transaction is uncertain, utilities may either collect the tax gross-up subject to refund plus interest, or in the alternative obtain written assurance that any tax gross-up would be paid if a favorable IRS ruling is not received within a time period specified by the utility. No utility should be allowed to pass on to the ratepayers any costs or losses associated with accepting written assurances."

Additional Ordering Paragraph

IT IS ORDERED that the following additional ordering paragraphs be inserted in D.87-09-026:

"10. Utilities shall not require any gross-up of contributions by a governmental agency to a utility or written assurance of payment of such gross-up for relocation or undergrounding work and which does not relate to the provision of service by the utility. Where written assurances have been obtained for such contributions, they shall be negated."

"11. Where a transaction is clearly taxable, utilities shall require payment of the gross-up for taxes or collect on any written assurances obtained from a governmental agency for contributions made by a governmental agency to a utility related to the provision of services by the utility."

"12. Where the taxability of a contribution of a governmental agency to a utility is uncertain, a utility may require payment of the tax gross-up or require a written assurance by the government agency to pay such gross-up if a favorable ruling is not received within a time frame specified by the utility. Payment of

such gross-up would be subject to refund including applicable interest upon receipt of a favorable IRS ruling and any written assurance similarly negated. No utility shall be allowed to pass on to the ratepayers any costs or losses associated with accepting written assurances."

"13. Respondents shall file appropriate revised tariffs to comply with this order."

"14. In all other respects D.87-09-026, as modified by D.87-12-028, remains in full force and effect."

This order is effective today.

Dated JUL 8 1988, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

Commissioner Frederick R. Duda, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser, Executive Director

ALJ/KT/jt

Decision _____

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the methods to be utilized by the Commission to establish the proper level of expense for ratemaking purposes for public utilities and other regulated entities due to the changes resulting from the 1986 Tax Reform Act.	I.86-11-019 (Filed November 14, 1986)

ORDER ON PETITION FOR MODIFICATION OF DECISION 87-09-026 OF THE CITY OF MOUNTAIN VIEW

On February 2, 1988, the City of Mountain View (Mountain View) filed its Petition for Modification of Decision (D.) 87-09-026, dated September 10, 1987. Mountain View requests that D.87-09-026 be modified to reflect Internal Revenue Service (IRS) Notice 87-82, IRS Bulletin No. 1987-51 (December 21, 1987) (Notice). Mountain View contends that the Notice confirms that contributions paid to public utilities by governmental entities for relocating or undergrounding utility facilities or in connection with threatened condemnation should not be considered to be taxable under Section 824 of the Tax Reform Act of 1986, Public Law No. 99-514 (TRA-86).

Mountain View requests that D.87-09-026 be modified so that:

(a) Utilities be permanently barred from charging a gross-up on payments by a governmental entity to a public utility where the payment "does not reasonably relate to the provisions of services by [the] utility...but rather relates to the benefit of the public at large." (Notice at 11.)

(b) Bar any gross-up of payments made by governmental entities that meet the

criteria of Section 1031 or 1033 of the Internal Revenue Code (I.R.C.).

(c) Utilities no longer be permitted to require "written assurance that the risk of contrary IRS ruling will be borne by the government agency..." regarding these sorts of payments. The risk of "contrary IRS ruling" has been eliminated by the Notice for these types of payments by governmental entities.

Mountain View requests that the Commission not modify D.87-09-026 regarding contributions for extending service to new governmental projects, since it does not agree with the IRS findings. Payments for extensions to new public buildings should continue to be collected by the utilities net of tax for two years from the issuance of D.87-09-026, provided that governmental entities provide adequate written assurance that they will pay any tax the IRS ultimately determines to be due. This will allow time for the municipalities to obtain regulatory or legislative relief from the IRS's adverse determination regarding payments for line extensions.

The State of California by and through the Department of Transportation (CalTrans) also filed a petition requesting modifications similar to Mountain View's and also in support of Mountain View's Petition for Modification of D.87-06-026 with respect to forbidding any gross-up of payments made by governmental entities that meet the criteria of Section 1031 or 1033 of the I.R.C. Since CalTrans' petition is similar to Mountain View's petition, it will not be repeated.

Responses to Petitions for Modification

Responses to the Petitions for Modification were filed by Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCal), and San Diego Gas & Electric Company (SDG&E). While the utilities were generally in agreement in their responses to the Petitions for Modification, there were several areas in

which their recommendations differed. In those situations the utilities will be identified by company names.

Utilities are in general agreement that the Notice clarifies the nontaxable nature of governmental payments for many relocations including highway relocation and most government-sponsored undergroundings. Moreover, the utilities are in agreement that the Notice is not as broad-sweeping as Mountain View suggests, since it includes conditional language which clearly limits the extent of potential exclusion. Based upon the conditional language included in the Notice, utilities believe that relocations and undergroundings performed in connection with a development requiring new utility services may still be taxable, even though payments for such relocation and undergrounding work are made by a governmental agency.

Utilities further agree that transactions qualifying under Sections 1031 and 1033 of the I.R.C. should be treated under those provisions and not as a taxable contribution. However, the utilities note that for this exemption to apply, there must first be a determination that the transaction qualifies under these Code provisions.

Utilities agree that the Notice clarifies the taxability of payments by governmental agencies for line extensions providing new services. This is the case whether or not the utility service is for the public benefit.

Proposals to Implement the Notice

A. Nontaxable Situations

In circumstances involving relocations and undergroundings which are clearly nontaxable under the Notice as well as transactions clearly qualifying under I.R.C. Section 1031 or 1033, PG&E will require neither a "gross-up" nor a written "contract to pay." Such circumstances include most, if not all, state highway relocation work as well as nearly all undergroundings of existing utility lines paid for by special assessment districts

or out of general governmental funds. When the transaction is clearly nontaxable, there is no disagreement among the three utilities filing responses as to the appropriateness of this approach.

B. Taxability Uncertain

In circumstances where relocations or undergroundings appear to be exempt from tax under the Notice but where some doubt exists, PG&E proposes to require a new, less onerous form of "written assurance" from a governmental agency. Such form will not require that the government agency receive a "favorable IRS determination" by September 9, 1989, but will merely cover the situation where there is an unexpected, adverse IRS determination. Under PG&E's proposal the government agency would be released from its "written assurance", if it could obtain a favorable IRS ruling. In those circumstances where PG&E continues to have reasonable doubt regarding the nontaxability of a governmental transaction, PG&E would request that the governmental agency receive a favorable IRS determination within a reasonable period. PG&E would collect the gross-up only if such a favorable determination could not be obtained. SoCal's position is similar to PG&E's.

SDG&E's position differs from the other two utilities in situations where the taxability of the governmental transaction is uncertain and the utility believes a reasonable risk of taxability exists. In that situation SDG&E believes the utility should be permitted to gross-up for taxes. SDG&E's reasons for allowing gross-up are:

1. Written assurances are an interim measure to be utilized only until the IRS issues a Notice of Revenue Ruling. Such notice has been issued.

2. Continuing to accept written assurances when there is a reasonable risk that the transaction is taxable is inconsistent with the decision's finding that the best

procedure to reduce ratepayer risk[1] and protect the utility is to require the utilities to collect the tax gross-up on all contributions (D. at 67).[2]

3. Grossing-up governmental contributions when the utility believes there is a reasonable risk of taxability is consistent with prudent tax collection practices. Vendors collect all pertinent taxes unless the vendee can prove the transaction is tax exempt. Any other practice puts the vendor (utility company) at risk for payment of tax.

4. It would be impractical, costly, and overly burdensome for SDG&E to accept written assurances pending further IRS direction. The only likely additional IRS direction is "Private Letter Rulings" because the IRS has already issued a generic Revenue Ruling ("Notice"). Private letter rulings are fact specific and not binding even when identical facts exist in another transaction. Each transaction requires a separate private letter ruling proceeding. Each year SDG&E engages in hundreds of

---

1 SDG&E and PG&E disagree regarding the acceptance of written assurances when taxability of the transaction is uncertain. The reason may be because PG&E has chosen Method Five and SDG&E the Maryland Method. The Maryland Method places the risk of not collecting the amounts secured by the written assurances on the utilities' shareholders; Method Five places this risk on the ratepayers.

2 A written assurance gives SDG&E nothing more than a right-to-sue. Given the costs of litigation and the technical nuances of governmental budgeting which can defeat a valid claim for money, a right-to-sue to collect tax dollars may not be worth the paper on which the "written assurances" are written.

If other utilities are willing to accept written assurances in lieu of grossing-up contributions for taxes, they should be permitted to do so. However, no utility should be allowed to pass on to ratepayers any costs or losses associated with accepting written assurances.

> projects involving governmental entities where the taxability of the transaction may be at issue. Because the decision presently requires utilities that receive written assurances to "cooperate" with the governmental entities attempting to obtain an IRS ruling that their transactions are not taxable (D. 74, Finding of Fact 9) SDG&E could ultimately be involved in hundreds of private letter ruling proceedings. To handle the additional work associated with these proceedings would require adding or contracting for personnel at ratepayer expense. This result is inconsistent with the decision's conclusion that contributors should bear the costs associated with their contributions, not the ratepayers.

C. Clearly Taxable Situations

Utilities agree that governmental transactions which are clearly taxable pursuant to the Notice should be grossed-up for taxes. Utilities state that it makes no sense to require written assurance against an adverse IRS determination when such IRS adverse determination already exists. Since the IRS has determined that service extension situations are taxable transactions, the utilities must now pay the taxes due on such transactions. Utilities are unanimous in their opposition to Mountain View's request that a gross-up not be applied in service extension situations, simply because Mountain View does not agree with the IRS ruling.

Discussion

Although Mountain View's and CalTrans' (Petitioners) requests for Modification of D.87-09-026 have been opposed by the utilities, the difference in positions taken by the parties are not as great as it appears. Utilities agree that they should not require any gross-up or written contract to pay for relocations and undergroundings which are clearly nontaxable under the Notice, as well as transactions clearly qualifying under I.R.C. Section 1031

or 1033. This includes most, if not all, state highway relocation work as well as nearly all undergroundings of existing utility lines paid for by special assessment districts or out of general governmental funds. Thus, the treatment of this type of governmental contributions is noncontroversial.

There is similarly agreement between petitioners and the utilities that certain transactions, namely service extension situations, are clearly taxable under the Notice. Utilities agree that such contributions should now be grossed-up and paid by the governmental agencies since the IRS has now come forth with its adverse determination by making such transactions taxable to the utilities. Mountain View, however, requests that D.87-09-026 not be modified to permit utilities to gross-up such transactions in order to enable the municipalities to obtain regulatory or legislative relief from IRS's adverse determination. By not modifying D.87-09-026, the municipalities would have until September 9, 1989 before the utilities would be able to collect on the tax gross-up of such contributions. The question at issue is whether in view of the negative IRS ruling in the Notice regarding service extension situations, should utilities be prevented from collecting such tax gross-up until September 9, 1989 in order to permit the municipalities an opportunity to obtain a favorable IRS determination? Since our primary goal in this matter is to protect the ratepayers from any undue risks, we believe the utilities should now be permitted to collect such tax gross-up without any further delay.

Finally, we will address the more controversial situation where there is some doubt as to the taxability or nontaxability of the contributions. First, we concur that where there is any doubt as to the taxability of a contribution the utilities should be allowed to make a determination as to the form of security necessary to ensure that such amounts will be paid, if the ultimate resolution is that such transactions are taxable. We will leave it

up to the utility to determine whether it should use PG&E's approach of a written assurance with no collection of the gross-up for taxes until a specified period of time has elapsed, or SDG&E's proposal to collect the tax gross-up subject to refund including interest should a favorable ruling be obtained, or a combination of the two methods. The determining factor should be whether the action taken unduly increases the risk to the ratepayers.

Therefore, **IT IS ORDERED** that D.87-09-026, as modified by D.87-12-028, is further modified as follows:

1. Additional Finding of Fact 10 is added to read:

   "Official notice is taken of Internal Revenue Service Notice 87-82, published in IRS Bulletin No. 1987-51, December 21, 1987, which provides guidance with respect to treatment of contributions in aid of construction after enactment of Section 824 of the Tax Reform Act of 1986, Public Law No. 99-514."

2. Additional Finding of Fact 11 is added to read:

   "Under IRS Notice 87-82 there is general agreement that payments made by governmental entities which are a prerequisite to the provision of services by the utility are taxable even though such facilities are conducted for the benefit of the community at large."

3. Additional Finding of Fact 12 is added to read:

   "There is general agreement that under IRS Notice 87-82 relocation payments received by utilities under a government program for placing utility lines underground or for the cost of relocating utility lines to accommodate the construction or expansion of a highway and not for the provision of service shall not be treated as a contribution in aid of construction and thus are clearly nontaxable. Utilities shall not require "written assurances" where the transaction is clearly nontaxable."

4. Additional Finding of Fact 13 is added to read:

"Mountain View disagrees with the Notice that payments for extensions to new public buildings are taxable. Mountain View requests that these payments be continued to be collected net of tax for two years from the issuance of D.87-09-026 to enable the municipalities to obtain regulatory or legislative relief from the IRS's adverse determination regarding payments for line extensions."

5. Additional Finding of Fact 14 is added to read:

"While the Notice clarifies the taxability or nontaxability of certain contributions, there is still a grey area that needs further resolution involving undergrounding or relocation and the provision of service."

6. Modify Finding of Fact 9 to read as follows:

"Although no methods were introduced during the hearings that showed by clear and convincing evidence that the IRS would not impose a tax on a particular transaction, except that contributions resulting from condemnation or the threat or imminence thereof or which are for a public benefit appear to be exempt from tax, IRS Notice 87-82 has clarified the taxability or nontaxability of certain contributions from governmental agencies although some uncertainty still remains regarding the tax treatment of certain types of relocations and undergroundings. Where there is still uncertainty as to whether a tax risk remains, we will allow the utilities to make a determination as to whether they will require the payment of the tax gross-up or be satisfied with a written assurance against adverse IRS determination to be obtained within a time span designated by the utility before the tax gross-up must be paid subject to refund should a favorable ruling be obtained. We caution the utilities that whatever choice they make, the ratepayer may not be charged with back taxes, penalties, or interest."

Conclusions of Law

1. Modify Conclusion of Law 2 to read as follows:

"All contributions and refundable advances should be assumed to be subject to federal income tax until the IRS rules otherwise, except that contributions by governmental agencies which result from condemnation or the threat or imminence of condemnation, or for relocating utility facilities or undergrounding under a government program and does not reasonably relate to the provision of service should not be considered taxable. If the utility believes that there is a risk of taxability of a transaction, it may request adequate written assurance (a contractual promise to pay) from the governmental agency that the risk of a contrary IRS ruling will be borne by the governmental agency or in the alternative require the payment of the tax gross-up. If a favorable IRS determination applicable to a particular type of government agency contribution is not received within a time frame specified by the utility, such transaction is presumed taxable and subject to gross-up until a favorable IRS determination is received. In the case where the gross-up is paid and a favorable determination is subsequently received, such payment is subject to refund plus applicable interest."

2. Add Conclusion of Law 20 to read:

"IRS Notice 87-82 has clarified the taxability or nontaxability of contributions made by governmental agencies for typical highway relocation or undergroundings and for extensions for new services, however leaves uncertain the taxability of certain other relocation and undergrounding work even though payments are made by a governmental agency."

3. Add Conclusion of Law 21 to read:

"Utilities should not require written assurance nor collect for tax gross-up where the transaction is clearly nontaxable."

4. Add Conclusion of Law 22 to read:

"Utilities should collect for tax gross-up where the transaction is clearly taxable even though the governmental agency making the contribution may disagree with IRS Notice 87-82."

5. Add Conclusion of Law 23 to read:

"Where the taxability of a transaction is uncertain, utilities may either collect the tax gross-up subject to refund plus interest, or in the alternative obtain written assurance that any tax gross-up would be paid if a favorable IRS ruling is not received within a time period specified by the utility."

Additional Ordering Paragraph

IT IS ORDERED that the following additional ordering paragraphs be inserted in D.87-09-026:

"10. Utilities shall not require any gross-up of contributions by a governmental agency to a utility or written assurance of payment of such gross-up for relocation or undergrounding work and which does not relate to the provision of service by the utility. Where written assurances have been obtained for such contributions, they shall be negated."

"11. Where a transaction is clearly taxable, utilities shall require payment of the gross-up for taxes or collect on any written assurances obtained from a governmental agency for contributions made by a governmental agency to a utility related to the provision of services by the utility."

"12. Where the taxability of a contribution of a governmental agency to a utility is uncertain, a utility may require payment of the tax gross-up or require a written assurance by the government agency to pay such gross-up if a favorable ruling is not received within a time frame specified by the utility. Payment of such gross-up would be subject to refund

including applicable interest upon receipt of a favorable IRS ruling and any written assurance similarly negated."

"13. Respondents shall file appropriate revised tariffs to comply with this order."

"14. In all other respects D.87-09-026, as modified by D.87-12-028, remains in full force and effect."

This order is effective today.

Dated _____, at San Francisco, California.