MidAmerican Energy Co. v. Commissioner, 114 T. C. 570 (2000)

Utilities must include unbilled revenue from utility services in taxable income for the year services are provided, and rate reductions to offset excess deferred tax are not deductible business expenses.

Summary

MidAmerican Energy Co. changed its accounting method in 1987 to include unbilled revenue in taxable income, but excluded gas costs from this calculation, contravening Section 451(f). The company also sought to deduct rate reductions made from 1987 to 1990 to compensate for excess deferred Federal income tax under Section 1341. The Tax Court ruled that MidAmerican's accounting method did not comply with Section 451(f) as it failed to include gas costs from the unbilled period in taxable income. Furthermore, the court held that the rate reductions were not deductible under Section 1341 because they were not repayments but rather reductions in future income.

Facts

MidAmerican Energy Co. , a public utility, changed its method of accounting for tax purposes in 1987 to include unbilled revenue in taxable income, in line with its financial and regulatory accounting. However, it excluded gas costs from the unbilled period from this adjustment. This method was challenged by the Commissioner. Additionally, following the Tax Reform Act of 1986, MidAmerican reduced its utility rates from 1987 to 1990 to offset excess deferred Federal income tax collected prior to the tax rate reduction. MidAmerican sought to deduct these rate reductions under Section 1341, claiming they were repayments of previously collected income.

Procedural History

The Commissioner audited MidAmerican's tax returns for 1987-1990 and determined deficiencies, rejecting MidAmerican's method of accounting for unbilled revenue and denying the claimed deductions under Section 1341. MidAmerican appealed to the U. S. Tax Court, which consolidated the cases and ruled against MidAmerican on both the unbilled revenue and Section 1341 issues.

Issue(s)

1. Whether MidAmerican's method of accounting for unbilled revenue, which excluded gas costs, complied with Section 451(f)?
2. Whether MidAmerican's reductions in utility rates from 1987 to 1990 to compensate for excess deferred Federal income tax were deductible under Section 1341?

Holding

1. No, because MidAmerican's method of accounting did not include in taxable income the revenue attributable to gas costs from the unbilled period, in violation of Section 451(f).
2. No, because the rate reductions were not repayments to customers but reductions in future income, and thus not deductible under Section 1341.

Court's Reasoning

The court found that MidAmerican's method of accounting for unbilled revenue violated Section 451(f) because it did not include gas costs in the unbilled period in taxable income, effectively using the disallowed cycle meter-reading method. The court emphasized that utility services are considered provided when available to and used by the customer, not when metered or billed. The court rejected MidAmerican's argument that its use of the purchased gas adjustment (PGA) and energy adjustment clause (EAC) mechanisms to recover gas costs obviated the need to accrue gas costs from the unbilled period, stating that these mechanisms addressed billing, not the timing of income recognition.

Regarding the Section 1341 issue, the court held that the rate reductions were not deductible because they did not constitute a repayment of previously collected income. The court distinguished between a deductible expense and a mere reduction in future income, noting that the rate reductions were not repayments to the same customers who overpaid, did not include interest, and were not actual out-of-pocket payments but adjustments to future rates. The court cited precedents where similar rate adjustments were not considered deductible expenses.

Practical Implications

This decision clarifies that utilities must include all revenue from utility services, including gas costs from the unbilled period, in taxable income under Section 451(f). This may require utilities to adjust their accounting practices to ensure compliance, potentially affecting their tax liabilities. The ruling also limits the ability of utilities to deduct rate reductions intended to offset excess deferred tax under Section 1341, as such reductions are seen as adjustments to future income rather than repayments. This could impact how utilities manage rate adjustments and deferred tax liabilities, and how they plan for tax deductions. Subsequent cases, such as Dominion Resources and WICOR, have addressed similar issues with varying outcomes, but this decision remains significant for its application of Section 451(f) and interpretation of Section 1341 in the context of utility rate adjustments.

