

# Report of the Committee on Tax Developments

## I. INTRODUCTION

As with the past year, 1989 was a year of adjustments and extensions of prior law rather than a year of new legislative initiatives or landmark court rulings. Several legislative proposals favorable to energy firms were introduced, but few were enacted in the major tax bill, the Revenue Reconciliation Act of 1989 (1989 Act).<sup>1</sup> The Bush proposal to restore reduced tax rates on capital gains produced several counter-proposals but was ultimately eliminated from the 1989 Act. Congress implemented a tax to finance the Oil Spill Liability Trust Fund put in place by the Tax Reform Act of 1986 (TRA).<sup>2</sup> The Internal Revenue Service (Service or IRS) released proposed regulations further defining mixtures eligible for the alcohol fuel income tax credit, while making further refinements through notices and announcements. Of note was the Supreme Court's ruling that utility customers' deposits were excludable from income of the utility.

## II. DEVELOPMENTS AFFECTING THE OIL, GAS, AND COAL INDUSTRIES

### A. Deductions and Exclusions

#### 1. Energy Credit

##### a. Legislative Developments: Extension of Energy Credit

The 1989 Act extended the expiration date of the energy credit allowable for solar energy, geothermal, and ocean thermal property from December 31, 1989, to September 30, 1990.<sup>3</sup> Credit percentages and other associated provisions were unchanged.

##### b. Cases

In *Levin Metals Corp. and Subsidiaries v. Commissioner*,<sup>4</sup> the Tax Court held that transportation equipment used by a recycling business in transporting scrap metal and other solid wastes between collection sites and recycling plants and within and between recycling plants was not eligible for the energy credit. The Tax Court relied on the distinction in the legislative history between transportation equipment integrally related to the recycling process and transportation equipment used to transfer waste between geographically separate sites.

In a separate yet related area, the Service determined that transportation equipment used to haul solid waste to a disposal facility qualified as equipment

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1. Pub. L. No. 101-239, 103 Stat. 2301 (1989).  
2. Pub. L. No. 99-514, 100 Stat. 2085 (1986).  
3. Pub. L. No. 101-239, § 7106, 103 Stat. 2301, 2306 (1989).  
4. 92 T.C. 307 (1989).

used in the collection of solid waste for purposes of tax-exempt financing.<sup>5</sup>

### c. Rulings—Energy Credit

The IRS clarified definitions in the energy tax credit area in several rulings. In Private Letter Ruling 89-44-030,<sup>6</sup> the Service held that the energy credit was available for rehabilitation expenditures for significant enlargement of an existing dam so long as the enlargement did not create significant adverse environmental effects. In this case, the Federal Energy Regulatory Commission had found that the project would not have significant adverse environmental effects. Further, the fact that the project included enlargement expenses in addition to rehabilitation expenses did not prevent an energy credit from being taken for the costs properly characterized as dam rehabilitation expenses.

Equipment that is qualified solar energy property constructed in 1989 is eligible for the energy credit even if not placed in service until after December 31, 1989. In Private Letter Ruling 89-46-076,<sup>7</sup> the Service determined that property of this type fell within the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amendment<sup>8</sup> for solar energy property because the property was constructed within the designated time period.

The Service examined the effect on the energy credit of subsequent developments in two private letter rulings. In Private Letter Ruling 89-51-013,<sup>9</sup> the Service ruled that second stage construction, for which no energy credit was claimed, would not impair the energy credit claimed on the original project. The Service noted that the second stage would not increase the installed capacity of the project above 25 megawatts and would divert water but would not create an impoundment of water. The ruling relied on a colloquy related to the extension of expiring energy credits enacted by TAMRA<sup>10</sup>.

In Private Letter Ruling 89-42-019,<sup>11</sup> the Service held that investor-owners of turbines would not be subject to recapture of the energy credit where the owners granted an option to the operating corporation to acquire the turbines as part of a Chapter 11 bankruptcy reorganization plan. The granting of an option would not be deemed a disposition of the property until the corporation exercised its option, at which time the owners would then be subject to recapture.

In Private Letter Ruling 89-09-003,<sup>12</sup> the Service ruled that capitalized

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5. Priv. Ltr. Rul. 90-02-049 (Oct. 18, 1989).

6. Priv. Ltr. Rul. 89-44-030 (Aug. 7, 1989).

7. Priv. Ltr. Rul. 89-46-076 (Aug. 24, 1989).

8. Pub. L. No. 100-647, § 4006, 102 Stat. 3342 (1988).

9. Priv. Ltr. Rul. 89-51-013 (Sept. 20, 1989).

10. See 113 CONG. REC. S15455 (daily ed. Oct. 11, 1988) (colloquy between Sens. McClure, Baucus, and Packwood).

11. Priv. Ltr. Rul. 89-42-019 (Aug. 31, 1989).

12. Priv. Ltr. Rul. 89-09-003 (Nov. 22, 1988).

expenditures incurred to repair and modify boilers burning natural gas so that they could be fueled by either natural gas or coal would constitute new section 38 property for purposes of the investment tax credit. The expenditures were not eligible for the energy credit, however, because the repairs were in the nature of extending the life of petroleum-fired boilers rather than retiring them as was the intent of Congress when it enacted the energy credit.

In one placed in service ruling,<sup>13</sup> the Service held that a public utility was not entitled to either an investment credit or a depreciation deduction because a nuclear power plant met only two of the four factors indicating when a unit was considered placed in service. In determining that the plant had not been synchronized, the Service cited a utility news release stating that the synchronization test that had been performed was one of the final tests to ready the plant for commercial operations. But it was only a test. Actual synchronization had not occurred. In addition, the Service found that the utility did not have the necessary permits and licenses because a 5% power license was viewed by the Nuclear Regulatory Commission as part of a test program and was not at a level commensurate with the plant's specifically assigned function.

## 2. Nonconventional Fuels Credit—Code Section 29

### a. Legislative Developments

The 1989 tax bill reported out of the Senate Committee on Finance would have extended by two years the production credit for nonconventional fuels, thus making the credit available for wells drilled or facilities placed in service before January 1, 1993.<sup>14</sup> In addition, the Senate would have made production of gas from a tight sands formation eligible for the credit even though the price of natural gas was no longer subject to price controls. Although the nonconventional fuel credit extension was not included in the final version of the bill, a colloquy between Senators Simpson and Bentsen indicated that the extension will be brought before the Senate Finance Committee in 1990.<sup>15</sup>

### b. Rulings

The IRS issued two private letter rulings interpreting definitions of nonconventional fuels. In Private Letter Ruling 89-34-067,<sup>16</sup> the Service ruled that the nonconventional fuel credit could be claimed for the period prior to determination that certain wells were tight formation wells under section 503 of the Natural Gas [Policy] Act (NGPA).<sup>17</sup> The Service reasoned that the

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13. Priv. Ltr. Rul. 89-42-002 (June 21, 1989).

14. SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED 16 (Comm. Print 1989).

15. 135 CONG. REC. S16657-58 (daily ed. Nov. 21, 1989).

16. Priv. Ltr. Rul. 89-34-067 (June 1, 1989).

17. 15 U.S.C. § 3413 (1988).

particular formation had historically been a tight formation. Later governmental determination was merely formal recognition of this fact.

In Private Letter Ruling 89-40-004,<sup>18</sup> the Service ruled that the proper definition of "tar sand" for purposes of the nonconventional fuels credit is the Federal Energy Agency administrative ruling definition in existence when the Crude Oil Windfall Profit Tax Act of 1980 (COWPA)<sup>19</sup> was enacted<sup>20</sup>. The Service rejected the definition adopted by the Department of Energy in December, 1980, because Congress could not have relied on that definition when enacting the credit provision.

In Private Letter Ruling 89-42-068,<sup>21</sup> the Service determined that the term "drilled" for purposes of applying section 29 to a coal seam refers to the "spudding in date," defined as the commencement of continuous drilling to the objective depth. The Service rejected a "placed in service" concept as the qualifying date. Such a concept would have required placing the well in a more completed state for production. The Service also ruled that, where a partnership acquires a working interest in a well or other property, the partnership is the taxpayer for purposes of the credit, and each person who is a partner at the time the qualified fuel is sold will be allocated the section 29 credit with respect to his or her distributive share of partnership income regardless of whether the person owned an interest in the partnership at the time of production.<sup>22</sup>

In Private Letter Ruling 89-50-026,<sup>23</sup> the Service defined what property was eligible for the credit as "new production." The Service determined that the NGPA definition of a "proration unit" of a reservoir was a more appropriate definition than the definition of property under section 614(a) of the code. The Service reasoned that this unit would not preclude a subsidy for the efficient development of a particular portion of a reservoir that had been tapped in some other portion prior to 1980.

### 3. Alcohol Fuel Income Tax Credit—Code Section 40

#### a. Regulations

Under proposed regulations,<sup>24</sup> a product will be considered a "mixture" of alcohol and gasoline or of alcohol and a special fuel if the product is derived from alcohol and either gasoline or a special fuel. This will be true even if the alcohol is no longer present as a separate chemical in the final product, provided there is no significant loss in the energy content of the alcohol. The regulations were in response to use of ethyl tertiary butyl ether (ETBE) as an

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18. Priv. Ltr. Rul. 89-40-004 (June 20, 1989).

19. Pub. L. No. 96-223, 94 Stat. 229 (1980).

20. FEA Rul. 1976-4, 41 Fed. Reg. 25,886 (1976).

21. Priv. Ltr. Rul. 89-42-068 (July 26, 1989).

22. *Id.*; see also Priv. Ltr. Rul. 89-15-019 (Jan. 10, 1989).

23. Priv. Ltr. Rul. 89-50-026 (Sept. 18, 1989).

24. 54 Fed. Reg. 48639 (1989).

octane enhancer, but the regulations are broad enough to encompass other mixtures. The proposed regulations would be effective as if enacted with the original provisions.

#### 4. Depreciation

##### a. Rulings

The Service ruled that an anthracite culm burning cogeneration facility would qualify as a waste reduction and resource recovery plant for purposes of determining depreciation deductions.<sup>25</sup> The anthracite culm resulted from the initial process of separating noncombustible material from marketable anthracite. The culm was to be burned with silt derived from a coal washing process that further separated marketable anthracite from waste. The culm and silt had historically been impounded on land adjacent to the coal mine. The Service determined that the culm and silt were "solid waste" under regulations promulgated pursuant to section 103 of the code and that the use of oil and coal as start-up fuel did not prevent the facility from qualifying as a waste reduction and resource recovery plant.

The Service continued to define the placed in service date for purposes of the depreciation deduction, although the rulings are also relevant for other purposes, including eligibility for the energy credit. In Private Letter Ruling 89-09-043,<sup>26</sup> the Service ruled on the proper placed in service date of a power and lime-producing plant. The lime portion of the facility would be a physical component of the boiler and would function as a pollution control device with respect to the power facility in addition to producing saleable lime. Because neither the power nor the lime-producing components of the facility could function individually in the manner in which they were designed to operate, the Service, relying on *Hawaiian Independent Refinery, Inc. v. United States*,<sup>27</sup> ruled that the facility was a single property. Therefore, the facility would not be considered placed in service until both components were placed in service for purposes of the transitional rules in the TRA for investment tax credit and accelerated depreciation.

In Private Letter Ruling 89-24-010,<sup>28</sup> the Service determined the placed in service date for the conversion of a utility plant that was abandoned after 12 years of construction before being placed in service. The plant will be converted to a cogeneration facility that will produce electricity and steam. The facts of the ruling state that with fewer than two-thirds of the gas turbines functioning the facility may only be able to produce enough process steam to satisfy its contractual obligation to a manufacturing plant and enough electric-

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25. Priv. Ltr. Rul. 89-24-032 (Mar. 17, 1989).

26. Priv. Ltr. Rul. 89-09-043 (Dec. 7, 1988).

27. 82-1 U.S. Tax Cas. (CCH) ¶ 9183 (Ct. Cl. 1982), *aff'd*, 697 F.2d 1063 (9th Cir. 1983), *cert. denied*, 464 U.S. 816 (1983).

28. Priv. Ltr. Rul. 89-24-010 (Mar. 10, 1989).

ity to satisfy initial contractual obligations to the utility. The Service ruled that the proper placed in service date would be when two-thirds of the gas turbines were functioning and the facility would be able to operate regularly in an integrated manner and at a level to receive the full contract price for the electricity and steam produced by the facility. The remaining turbines will be considered placed in service as each turbine becomes operational.

In Private Letter Ruling 89-22-008,<sup>29</sup> the Service examined the sale-lease-back of public utility property to determine treatment of unamortized accumulated deferred investment tax credits and unamortized deferred tax reserves resulting from accelerated depreciation. The Service concluded that, unlike the situation when public utility property is sold outright, the utilities and their ratepayers would continue to bear the cost of the property over the lease term, with regulated depreciation expense being replaced by a regulated rental expense. The Service held that the utility could ratably amortize the unamortized investment credits over a period no shorter than the lease term to reduce cost of service for ratemaking purposes and on its regulated books of account.

## 5. Depletion Deduction

### a. Legislative Developments

Several Senators introduced Senate Bill 828, the Enhanced Oil and Gas Recovery Act of 1989, which would provide tax incentives for the removal of crude oil and gas through enhanced recovery techniques.<sup>30</sup> The tax incentives fall into four categories: (1) an increase in the percentage depletion rate for domestic oil and gas recovered through enhanced recovery techniques to 27.5%, phased-down as the price of crude oil increases above \$30 per barrel adjusted for inflation; (2) an increase in the net income limitation on this oil and gas from 50% to 100%; (3) the inapplicability of the alternative minimum tax preferences for percentage depletion and intangible drilling and development costs (IDCs) to the deductions attributable to this oil and gas; and (4) a 10% research and development tax credit on research to discover or improve tertiary recovery methods.

Hearings on Senate Bill 828 were held before the Senate Finance Subcommittee on Energy and Agriculture on August 3, 1989. At the hearing, Treasury advocated the President's proposal which would: (1) replace the 50% net income limitation with a limitation based on 100% of net income in the case of all percentage depletion allowable under the Code; (2) allow percentage depletion to be claimed by a transferee of proven oil or gas producing property; (3) eliminate 80% of the present law preference attributable to IDCs incurred by independent producers for exploratory drilling; and (4) provide a 10% tax credit for certain projects utilizing tertiary enhanced recovery

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29. Priv. Ltr. Rul. 89-22-008 (Feb. 27, 1989).

30. S. 828, 101st Cong., 1st Sess., 135 CONG. REC. S4181-83 (daily ed. Apr. 18, 1989).

techniques.<sup>31</sup>

The 1989 tax bill reported out of the Senate Finance Committee included a provision that would have eliminated the net income limitation percentage depletion deductions on marginal domestic oil and gas production.<sup>32</sup> The term "marginal production" would have generally included (1) domestic crude oil and natural gas produced from stripper wells and (2) domestic crude oil that is "heavy" oil.<sup>33</sup> The provision was not included in the final version of the 1989 Act.

#### b. Rulings

In Private Letter Ruling 89-37-033,<sup>34</sup> the Service held that the small producer depletion allowance would continue to be available to partners following distribution of the partners' interests in oil-producing property and subsequent contribution of the interests by participating partners to a new corporation. Although the depletion allowance is not available to a transferee of any interest in a proven oil or gas property transferred after December 3, 1974, the Service did not deem the partners in this transaction to be transferees to the extent that they were entitled to a percentage depletion with respect to the proven property before the transaction. The Service reasoned that the partners would merely be receiving their proportionate share of partnership property in respect of which they, as partners, were qualified to claim percentage depletion deductions prior to the distribution. Similarly, contribution of interests to the new corporation would not affect the deduction to the extent partners were entitled to a deduction immediately prior to the contribution.

In Private Letter Ruling 89-41-002,<sup>35</sup> the Service ruled that a nonrecourse loan secured by a corporation's overriding royalty interest in oil and gas properties was not in substance economically equivalent to a production payment. The mineral interest involved was not an economic interest in mineral in place because the interest was not solely satisfied from the production of minerals from the burdened interest, but could also be satisfied by proceeds of the sale of the overriding royalty interest.

### B. Mineral Interests and Royalties

#### 1. Cases

Based on pre-1986 law, the Tax Court held in *Louisiana Land and Exploration Co. and Subsidiaries v. Commissioner*<sup>36</sup> and *Houston Oil and Minerals*

31. Daily Report for Executives (BNA) No. 149 at L-1 (Aug. 4, 1989).

32. SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED 198 (Comm. Print 1989).

33. Heavy oil has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit.

34. Priv. Ltr. Rul. 89-37-033 (June 20, 1989).

35. Priv. Ltr. Rul. 89-41-002 (June 16, 1989).

36. 92 T.C. 1340 (June 27, 1989).















