BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

981743-EI

In the Matter of Florida Power & Light Company's Request for Confidential Classification in the Grey Tax Audit; Audit Control No. 98-190-4-1	))))	FILED: November 25, 1998

Exhibit A

CONFIDENTIAL DOCUMENTS

x-ref 12833-98
DOCUMENT NUMBER-DATE
13327 NOV 25 98
FPSC-RECORDS/REPORTING
00-0291
217104

CONFIDENTIAL

SUMMARY OF SIGNIFICANT PROCEDURES

A Reviewed 1995, 1996, and 1997 tax returns.

B Read internal audits pertaining to federal tax.

Obtained a list of FPL settlements with the IRS for the past five years and reviewed part of the IRS revenue report for these settlements.

Obtained a list of all items now pending in litigation with the IRS.

Interviewed company personnel to obtain an explanation of the issues involved in the settlements in the past five years and issues now in litigation.

Reviewed deferred tax accounts.

CONFIDENTIAL

AUDIT DISCLOSURE 1

SUBJECT: DEFINITION OF GREY TAX AREAS

STATEMENT OF FACTS:

The company representative stated they do not have a definition of grey tax areas. We asked what the company criteria was for deciding to take an aggressive stand or position on a tax item. The company stated that they do not have any criteria in writing. They may research a position and determine what the probability of success would be. In answer to our request for a list of grey tax areas and/or a list of aggressive stands, FPL provided us with a list of FPL tax items that are in litigation with the IRS.

A Also, after reviewing FPL Company tax returns for 1995, 1996 and 1997, we determined that they do report certain items on the IRS Form 8275, Disclosure Form. The company explained that these are items that FPL believes would be raised by the IRS, and they are national issues. National issues are issues that the IRS is raising with other utilities.

B We asked for an explanation of the litigation issues and the issues disclosed on Form 8275. For each litigation issue we also asked for the years effected, the amounts for each year, and the date an amended return was filed. They provided us with a representative to discuss the issues along with a spreadsheet showing the information. This is included as an exhibit to this disclosure.

Litigation Issues

The issues were separated into issues that FPL was claiming a refund for and issues on the tax returns that the IRS was disputing with FPL.

FPL Refund Claim Issues In Litigation

A. Fuel Tax Credit
B. Repair Expense Deduction
C. Transitional Rules-Depreciation
D. Transitional Rules- ITC
E. 1341 Deduction
F. Research and Experimental Credits.

Other FPL Litigation Items

G. Asbestos Removal Costs
H. Depreciation on Asbestos Removal Costs
I. Research & Experimental Credits.

C FPL stated that they are not recording any interest for any of the items under litigation. The company stated that they recorded deferred tax for one position that is now under litigation. That

CONFIDENTIAL

A

is the Section 1341 position. This is discussed under section E below. In order for staff to determine that this is the only litigation item for which the company is recording deferred tax, staff selected the month of June 98 to review the deferred tax recorded. Staff determined that the company was also recording deferred tax for the ITC transitional depreciation litigation matter. This is discussed under sections C and D below.

A. Fuel Tax Credit.
This is a dollar for dollar tax credit on tax for "certain off highway vehicles." The company identified and stated that they were entitled to a refund for these vehicles. The company filed an amended return for the years 1988 through 1992 for a total amount of $833,119 in December 1995. IRS has a disagreement with the vehicles that FPL identified as off highway use.

B. Repair Expense Deduction - This issue addresses the expense so the effect on the tax return would be 35%.

This was an item FPL brought up to the IRS. FPL has taken the position that certain items capitalized should have been deductible repairs for tax purposes. For example, a gasket could cost $700,000. The PSC says this is a retirement unit. FPL says this particular gasket does not extend the life and should be expensed for tax purposes. FPL and the IRS engineers are in the process of determining this issue. The disputed expense amount for 1988 through 1992 is $210,926,534. The amended court petition was filed in May 96.

C and D. Transition Rules - Depreciation and ITC - The depreciation is a 35% issue and the ITC is a dollar for dollar credit.

In 1986 the investment tax credit was repealed. At that time, transitional rules were put into effect. To take advantage of the transitional rules for ITC there had to be a binding contract as of March 1986 and for depreciation there had to be a binding contract as of December 1986. If a binding contract was in effect at these dates, the transitional rule allowed FPL to continue to take ITC and depreciation with the method used prior to the Tax Reform Act of 1986. FPL says that state law obligates them to serve all people in franchise areas. The company is claiming any upgrades needed or new items needed to meet their obligations, for the franchise areas, constitutes a binding contract. Therefore, the company claims depreciation for 1988 through 1992 and ITC for 1987 through 1990 for items connected with the obligations in the franchise areas in the amounts of $7,373,756 depreciation and $125,263,911 for ITC. The amended tax return was filed in December 95.

B

The company stated that deferred taxes were recorded for the tax years 1996 and 1997 for depreciation portion calculated for those years. As explained by the company, beginning with tax year 1996 the company calculated tax depreciation expense based on the ACRS method of depreciation for property additions purchased or constructed to meet the requirements claimed under the transitional rules.

CONFIDENTIAL

A The tax depreciation calculated in 1996 and 1997 using ACRS was for vintage years 1987, 1988, 1989 and 1990 (the years the company claims the state law constitutes a binding agreement and the transitional rules say ACRS is the method to use.) This was also done for 1998. The company explained that prior to 1996 the tax depreciation was calculated on MACRS which in effect was calculating tax depreciation as if the obligation in the franchise areas under state were not binding.

F AND I. Research and Experimental Credits - This is a dollar for dollar credit.

For the years 1989 through 1992, the IRS said that none of the items claimed on FPL's returns qualified as research and experimental credits. The amount was $5,739,134. FPL said that the IRS did not give a reason why these would not qualify and are fighting this in litigation. FPL performed a study of all other items in the company and came up with more items that they believed would qualify for research and experimental credits in the additional amount of $2,301,477 for the years 1989 through 1992. FPL filed an amended return for the additional amount in December 1995.

G and H. Asbestos Removal - This issues address the expenses dollars. The effect on the tax return would be 35%.

The IRS says that the money spent to remove asbestos should be capitalized. FPL says costs to remove asbestos is a current deduction. IRS says that the elimination of a potential health hazard increases the value of the property. The total disputed asbestos costs net of depreciation calculated by FPL for 1988 through 1992 is $11,623,014.

E. 1341 Deduction
This is a dollar for dollar deduction on the tax calculation.

Background

The corporate tax rate was 46% up to and including 1986. The rate was reduced to 34 percent in mid-1987. For the years 1987, 88 and 89 the customers were billed at rates which were established prior to the tax rate reduction to 34%. The PSC required the company to submit a tax saving filing in 87, 88 and 89 and to make refunds to customers for billing with rates that included 46% taxes when tax rates were actually 34%. In 1990 the commission ordered FPL to roll back rates across the board, reducing each rate class by 65 cents.

For the years 87, 88 and 89 this tax savings refund was recorded as a revenue reduction like a normal refund by debiting revenues and crediting the refund account.

Issue

The issue is described in the IRS "Coordinated Issue Papers" dated April 24, 1995. These

confidential

papers are not official pronouncements by the IRS, but set forth the IRS' current thinking. The excess deferred taxes and section 1341 issue is as follows:

"Whether the taxpayer, a regulated public utility, may compute its Federal income tax liability under the provisions of section 1341(a) of the Internal Revenue Code after making rate reductions ordered by the appropriate regulatory authority related to 'excess deferred taxes' created as a result of the lowering of the Federal statutory tax rate by the Tax Reform Act of 1986".

According to the paper "If an item is to be granted special computations provided by Section 1341, that item must be shown to have been included in gross income in a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item ((1341(a)(1))." Also, the IRS must consider the item a deduction to income, not a reduction of income. The paper gives examples of three prior cases Iowa Southern, Roanoke, and SouthWestern Energy; and points out that "As the 'return' of excess deferred taxes by regulatory bodies represents a future reduction in income and not a current deduction from income, the provisions of Section 1341 are not available."

Positions

FPL's position is that they are refunding the rates back to the customer because of the rate reduction by the commission in 1990 and that part of that 65 cent rate roll back included excess deferred taxes, which were collected at 46%. The IRS believes that the refund is a subsequent event taking place in 1990 and forward, not a result of a refund flowing back to the customer and not a Section 1341 item. FPL still contends that the excess deferred tax piece in the rate reduction belongs to prior years.

FPL believes that they are entitled to Section 1341 treatment.

A

In 1990 the company started to take the Section 1341 treatment on the tax return. Because of the dispute, the company recorded a deferred income tax to offset the current tax deduction in the current year. The journal entry would be debit deferred tax expense (account 410) and credit accumulated deferred income taxes (account 283). The credits claimed by the company total $11,777,802 for 1988 through 1992.

B

Review of 1995, 1996 and 1997 FPL Company tax returns (Disclosure Form 8275)

Staff reviewed the tax returns in particular to determine if they filed Form 8275, Disclosure Statement. The company filed this form in 1995 and 1997.

In 1995 they disclosed that they were making an IRC Section 1341 adjustment in the amount of $3,210,275 for a refund of excess deferred taxes to customers. This is discussed above under E,

CONFIDENTIAL

AUDIT DISCLOSURE 2

A

SUBJECT: INTERNAL AUDIT REGARDING MEALS EXPENSE

STATEMENT OF FACTS:

Staff review of an internal audit regarding Business Meals, September, 1998, determined that when excluding 50% of business meal expenses for tax purposes, the company double counted meals which were included in capitalized costs, resulting in an overstatement of FPL's taxable income and tax liability. One report used by corporate tax to determine taxable income included both capital meals and expense meals. The other report used included only capital meals. The people who calculated taxes added both reports together and were not made aware that the capital meals were included in the first report beginning in 1992. Therefore, capital meals were double counted for the taxable income from 1992 through 1996.

The double counting of capital meals was calculated to be $2.7 million for the years 1993 through 1996. This would have a favorable tax effect of $435,000. The internal audit stated that the corporate tax department will provide an adjustment to the IRS for inclusion in the current review. The 1997 tax return was not submitted yet, and will reflect the proper adjustment.

FPL
Review of Internal Audits

VW 10/28/98
RG 10/13/98

1. Contribution Tax Reporting - Process Review - March 1997

Audit was performed to provide the Tax Dept with an assessment on how the tax reporting process for [illegible] charitable contributions could be simplified and [illegible] [illegible] [illegible] regulations for paying [illegible] contributions [illegible] written acknowledgment from the [illegible] organization. Report suggested [illegible] an acknowledgment [illegible] [illegible] contribution.

2. Review of Business Unit - September 1995

FPL noted that items [illegible] were [illegible] [illegible] was [illegible] to review. The audit determined that [illegible] [illegible] since 1992 had been [illegible] [illegible] - resulting in overstatement of FPL's [illegible] [illegible] [illegible] capital [illegible] in 1992 [illegible] [illegible] [illegible] (while [illegible] [illegible])

The possible overstatement of capital was calculated to be $7.7 million which would [illegible] tax [illegible] $4[illegible] for the years 1993 and 1996. Consequently this would [illegible] adjustment to [illegible] [illegible] [illegible] April 1997. The return was not [illegible] yet, it will reflect the proper adjustment.

(detail) - 901 EAC summary report for 1992 was changed to contain both O&M & capital [illegible] [illegible] [illegible] [illegible] charge to the FPL report to get [illegible] EAC [illegible] -

- Confidential -

Doc No. PBC

Issue Date

3	98-01	MCI Special	01/13/98
4	98-02	LDS Graphs - Nuclear	01/28/98
5	98-03	PGBU - Dimineralized Water Contract Admin.	01/28/98
6	98-04	Payroll Audit	01/30/98
7	98-05	Merit System Audit	02/02/98
8	98-06	Key Contributor Calculation Review	02/04/98
9	98-07	Planning Development & Quality - Consulting	02/11/98
10	98-08	Directors' Fees and Expenses	02/13/98
11	98-09	Review of Pay Agents	02/20/98
12	98-10	Internet Transmissions to Collection Agency	02/20/98
13	98-11	Power Generation Procurement Special	02/26/98
14	98-12	Correspondence - Internet & Research	02/20/98
15	98-13	Thermo Lag Upgrade Project	03/03/98
16	98-14	PTN Contract Admin Cafeteria/Daycare Follow-Up	03/09/98
17	98-15	ESI - PSI Special Follow-Up	03/09/98
18	98-16	PTN Tool Removal Process	03/16/98
19	98-17	LDS Graphs - HR	03/17/98
20	98-18	DSSN Special - UTILX T&E	03/18/98
21	98-19	Municipal / Sales Tax Exemption Process Review	03/19/98
22	98-20	Fleet State Tag Audit	03/20/98
23	98-21	Church & Tower Review Special	03/24/98
24	98-22	PGBU - Demineralized Water Cost Savings	03/24/98
25	98-23	Customer Service Claims	03/25/98
26	98-24	Critical Unix Servers - Power Billing	03/27/98
27	98-25	Critical Unix Servers - TWS	03/27/98
28	98-26	Critical Unix Servers (PARIS)	03/27/98
29	98-27	Critical Unix Servers - TCMS/2	03/27/98
30	98-28	Re-Test SEOS Server - Document Image	03/27/98
31	98-29	PO/LDS Review	04/02/98
32	98-30	FPL Services - Server	04/16/98
33	98-31	EMT Confirmation Process	04/20/98
34	98-32	PTN Thermo Lag Bid Compliance	04/21/98
35	98-33	Officers' Expense Audit	04/29/98
36	98-34	Risk Management Policy Review #2	05/06/98
37	98-35	Executive Compensation Audit	05/11/98
38	98-36	OPAL Security	05/15/98
39	98-37	CPO Review - Follow-Up	05/22/98
40	98-38	PGBU Plant Megawatt Calculations	05/27/98
41	98-39	Variable Work Schedule - Flex Time	05/27/98
42	98-40	Distribution Special - Conflict of Interest	06/02/98
43	98-41	Line Clearing Contract Review	06/09/98
44	98-42	Commodity Pricing & Procedures	06/23/98
45	98-43	PD Procurement - Planning and Scheduling	06/24/98
46	98-44	Disaster Recovery Plan	06/25/98
47	98-45	Disaster Recovery Plan (DRP) - Hot Site Test - TCMS	06/25/98
48	98-46	Disaster Recovery Plan (DRP) - Hot Site Test - EIS	06/25/98
49	98-47	Disaster Recovery Plan (DRP) - Hot Site Test - CIS II	06/25/98
50	98-48	Disaster Recovery Plan (DRP) - Hot Site Test - PassP	06/25/98
51	98-49	Inter-company Billing Process Review	06/26/98

Doc	No.		Issue Date
52	98-50	Death Checks	06/30/98
53	98-51	Company Car Program	06/30/98
54	98-52	LDS/METro Authorization Limits	06/30/98
55	98-53	LDS / METro Authorization Levels	06/30/98
56	98-54	Check Refund Special	07/29/98
57	98-55	Gas Billing Process Review	08/07/98
58	98-56	Credit Policy Review	07/23/98
59	98-57	Year 2000 - Phase II - IM	08/07/98
60	98-58	Year 2000 - Phase II - Customer Service	08/07/98
61	98-59	Year 2000 - Phase II - Distribution	08/07/98
62	98-60	Year 2000 - Phase II - EMT	08/07/98
63	98-61	Year 2000 - Phase II - Finance	08/07/98
64	98-62	Year 2000 - Phase II - FPL Energy	08/07/98
65	98-63	Year 2000 - Phase II - FPL Energy	08/07/98
66	98-64	Year 2000 - Phase II - HR	08/07/98
67	98-65	Year 2000 - Phase II - Sales & Marketing	08/07/98
68	98-66	Year 2000 - Phase II - Nuclear	08/07/98
69	98-67	Year 2000 Phase II - Power Delivery	08/07/98
70	98-68	Year 2000 -- Phase II - Power Generation	08/07/98
71	98-69	PTN Payroll Process	08/19/98
72	98-70	EMT Procedures Review	08/21/98
73	98-71	EMT Application Evaluation - Security	08/31/98
74	98-72	Review of Business Meals	09/04/98
75	98-73	Distribution Trench Special	09/14/98
76	98-74	PGBU - Expense Report Special	09/14/98

Doc	No.		Issue Date
2	97-01	South Dade Mitigation Bank (SDMB) Special Audit (R. H	02/04/97
3	97-02	PSL Procurement Special (Indian River Insulation)	02/05/97
4	97-03	St. Lucie Digital Dosimetry Unix Server	02/06/97
5	97-04	Turkey Point Digital Dosimetry Unix Server	02/06/97
6	97-05	Conflict of Interest Special - General Office Print Shop	02/11/97
7	97-06	PTN Consumable Storeroom	02/11/97
8	97-07	Power Supply Unix Servers	02/17/97
9	97-08	Administration of Insurance for Non-Utility Operations	02/24/97
10	97-09	Security Review of the HR File Server at G.O.	02/27/97
11	97-10	Customer Bill on the Web	02/28/97
12	97-11	Oil Spill Preparedness and Prevention	03/04/97
13	97-12	Review of Distribution Operations Self-Audit	02/05/97
14	97-13	South Dade Mitigation Bank Special (R.N. Kessler)	03/05/97
15	97-14	Parts A/P Unix Server	03/06/97
16	97-15	Treasury Workstation	03/11/97
17	97-16	Document Image Unix Server	03/18/97
18	97-17	Bayloan Investment Bank	03/20/97
19	97-18	Merit System-Application & Unix Security Assessment	03/21/97
20	97-19	PGBU Special (Fred Taraschke & the 120 Doctor)	03/27/97
21	97-20	Fixed Payroll Distribution	03/28/97
22	97-21	Real Time Pricing	03/18/97
23	97-22	Passport Security Review	03/31/97
24	97-24	Contribution Tax Reporting Process	03/31/97
25	97-25	Brevard Service Center	04/23/97
26	97-26	Special Audit - Fleet Services' Construction Equipment	04/28/97
27	97-27	Distribution Vendor Review	04/29/97
28	97-28	Land Management Special - Expense Report Review	05/01/97
29	97-29	FPL Soft Political Contributions	05/01/97
30	97-30	Prepayment Service Option	05/01/97
31	97-31	Keith & Schnars, P.A. - Conflict of Interest Special	05/13/97
32	97-32	Computer Operations	05/15/97
33	97-33	Wireless and Fiber Leveraging	05/22/97
34	97-34	PTN Consumable Storeroom Follow-Up	06/04/97
35	97-35	OPAL Controls Review	06/12/97
36	97-36	Parts Accounts Payable	06/13/97
37	97-37	Conflict of Interest Customer Service	06/12/97
38	97-38	OPAL Technology Review	06/16/97
39	97-39	Workers' Compensation Follow-Up	06/18/97
40	97-40	Westinghouse Litigation Credits	06/26/97
41	97-41	PGBU / ESI Payroll Review	06/26/97
42	97-42	Risk Mgt. & Johnson & Higgins Non-Utility Workflow Pr	06/26/97
43	97-43	Turkey Point HR Manager - Special	06/26/97
44	97-44	Daytona Radio Shop Special - Special Investigation - B	06/27/97
45	97-45	Fuel Procurement	06/27/97
46	97-46	Corporate Accident Reporting Process	06/30/97
47	97-47	Disaster Recovery Plan	06/30/97
48	97-48	Indiantown Cogeneration Actual Energy Cost	06/30/97
49	97-49	FPL Energy Services	07/07/97
50	97-50	Megatran Allegation	07/10/97
51	97-51	Distribution Authorization Review	07/15/97

CONFIDENTIAL

Doc	No.		Issue Date
52	97-52	Energy Trading & Risk Mgmt. Systems Application Sec	07/28/97
53	97-53	EBI Special (Personal Systems)	07/31/97
54	97-54	Supply Chain Catalog (SCSB)	08/05/97
55	97-55	Parts Authorization	08/05/97
56	97-56	Orimulsion - Manatee Plant (Contract Provisions)	08/12/97
57	97-57	Gladiolus Inventory Services Review	08/11/97
58	97-58	Tax Data Security	08/19/97
59	97-59	PGBU Barging SIS	08/14/97
60	97-60	G.O. Construction - Cafeteria / Fitness Center	08/25/97
61	97-61	PTN Contract Administration (Cafeteria & Daycare)	08/25/97
62	97-62	Cancel / Replace Audit	08/25/97
63	97-63	PTN Contract Admin. (EBI Nuclear & Plant Maint. Bld)	08/28/97
64	97-64	Net Energy for Load Reporting	09/09/97
65	97-65	EDRC - Substation Project	09/11/97
66	97-66	Mitigation Banking Audit Revenues	09/15/97
67	97-67	Cafeteria Invoicing	09/16/97
68	97-68	EBIT's Competitors Evaluation of Credit Risk	09/16/97
69	97-69	EBET Supplier Authorization	09/16/97
70	97-70	Doswell Policy Review	09/18/97
71	97-71	Claims Operations	09/23/97
72	97-72	Environmental Reserve	09/25/97
73	97-73	Procurement Process	09/24/97
74	97-74	PSL Steam Generator	09/30/97
75	97-75	Fleet 2000 Application Security	10/7/97
76	97-76	PTN Computer Security	10/14/97
77	97-77	St. Lucie Plant Inventory and Repairable Process	04/07/97
78	97-77	PSL Nuclear Inventory Refurbish	10/23/97
79	97-78	Marketing Information System Payment Control Team	10/27/97
80	97-79	EBI Special Follow-Up Audit	10/31/97
81	97-80	Turner Apportion Security	10/30/97
82	97-81	LDS Authorization Levels - CS	11/03/97
83	97-82	EBET Application Security Implementation	11/11/97
84	97-83	LDS Administrative Review	11/12/97
85	97-84	Sales of Excess Land	11/17/97
86	97-85	PTN Disposal of Scrap	11/17/97
87	97-86	Migration of PSSS User ID's into Parts	11/19/97
88	97-87	LDS Graphs - Power Generation	12/04/97
89	97-88	Accounting LDS Authorization Levels	12/04/97
90	97-89	On-line JV System	12/04/97
91	97-90	Year 2000	12/05/97
92	97-91	Interim - Risk Management Policy	12/09/97
93	97-92	Check Free	12/16/97
94	97-93	EBIT's LDSI Security Reports	12/18/97
95	97-94	Plant Administrative Process and Procedures Audit	12/18/97
96	97-95	EBET Process Review	12/19/97

RJ 10/22/98

NOTES FROM MEETING WITH DON CHASMAR AND DAVE HUSS RE GREY TAX MATTERS. 10/13/98. AND OTHER MEETINGS WITH DAVE HUSS

1. Definition of grey tax matters.

A The company representative says that they do not have a definition of a grey tax area. The company report certain items in the IRS From 8275, Disclosure Form. The company explained that these are items that FPL believes would be raised by the IRS, and they are national issues. Items on 8275 are addressed in Section 5 below.

2. Utility's criteria for determining grey tax areas.

The company does not have any criteria in writing. They may research a position and determine what the probability of success would be.

3. Litigation issues.

When asked for a list of any grey tax issues, the company provided a list of items currently in litigation with the IRS from 1988 through 1992. The list is included as wp 54-1.

The issues were separated into issues that FPL was claiming a refund for and issues on the tax returns that the IRS was disputing with FPL.

FPL Refund Claim Issues In Litigation

A. Fuel Tax Credit
B. Repair Expense Deduction
C. Transitional Rules-Depreciation
D. Transitional Rules- ITC
E. 1341 Deduction
F. Research and Experimental Credits.

Other FPL Litigation Items

G. Asbestos Removal Costs
H. Depreciation on Asbestos Removal Costs
I. Total Asbestos issue
J. Research & Experimental Credits.

B FPL stated that they are not recording any interest for any of the deficient items under litigation. The company states that they recorded deferred tax for one position that is now under litigation. That is the 1341 position. This is discussed under section E below. recording of deferred tax for another litigation item. See page 6 for

We asked the company to explain each issue. They provided us with a representative to discuss the issues. They also provided us with a spreadsheet showing the issues, the years at issue, the amounts for each year, and the date an amended return was filed. See WP 54-2.

A. Fuel Tax Credit.
This is a dollar for dollar reduction on tax for "off highway vehicles" identified and entitled to refund for federal tax for off highway use. The company filed an amended return for the years 1988 through 1992 for a total amount of $833,119 in December 1995. IRS has a disagreement with the vehicles that FPL identified as off highway use. WP 54-2.

B. Repair Expense Deduction - This is a 35% deduction.
This was an item FPL brought up to the IRS. FPL has taken the position that certain items capitalized should have been deductible repairs for tax purposes. For example, a gasket could cost $700,000. The PSC says this is a capital unit. FPL says this particular gasket does not extend the life and should be expensed for tax purposes. FPL and the IRS engineers are in the process of determining this issue. The total amount for 1988 through 1992 is $210,926,534. The amended tax return was filed in May 96. WP 54-2.

C and D. Transition Rules - Depreciation and ITC - The depreciation is a 35% issue and the ITC is a dollar for dollar credit.

In 1986 the IRS repealed the ITC. At that time transitional rules were put into effect. To take advantage of the transitional rules, for ITC there had to be a binding contract as of March 1986 and for depreciation there had to be a binding contract as of December 1986. If a binding contract was in effect at these dates, the transitional rule is that FPL could continue to take ITC and depreciation with the method used prior to the tax repeal in 1986. FPL says that their franchise agreements obligates them to serve all people in franchise areas. The company is claiming any upgrades needed or new items needed to meet their franchise agreements dated as of the above dates constitutes a binding contract. Therefore, the company claims depreciation and ITC for 1998 through 1992 for items connected with the franchise agreements in the amounts of $7,373,756 depreciation and $125,263,911 for ITC. The amended tax return was filed in December 95. WP 54-2.

A

E AND J. Research and Experimental Credits - This is a dollar for dollar credit.

For the years 1989 through 1992, the IRS said that none of the items claimed on FPL's returns qualified as research and experimental credits. The amount was $5,739,134. FPL said that the IRS did not give them a reason why these would not qualify and are fighting this in litigation. FPL performed a study of all other items in the company and came up with more items that they felt would qualify for research and experimental credits in the additional amount of $2,301,477 for the years 1989 through 1992. FPL filed an amended return for the additional amount in December 95. WP 54-2.

G,H and I. Asbestos Removal - This is a 35% issue.

The IRS says that the money spent to remove asbestos should be capitalized. FPL says costs to remove asbestos is a current deduction. IRS says that the elimination of a potential health hazard increases the value of the property. The total asbestos costs net of depreciation calculated by FPL for 1998 through 1992 is $11,623,014. 54-2

E. 1341 Deduction

This is a dollar for dollar credit on the tax calculation.

The issue w/ the IRS is described on 54-7.

Background

The corporate tax rate was 46% up to and including 1986. The rate was reduced to 34 percent in 1987. For the years 1987, 88 and 89 the customers were billed at rates which included the 46% tax rate. The PSC required the company to submit a tax saving filing in 87, 88 and 89 to make refunds back to the customer for billing with rates that included 46% taxes when taxes were actually 34%. In 1990 the commission ordered FPL to roll back rates across the board, reducing each rate class by 65 cents.

For the years 87,88 and 89 this tax savings refund was booked as a revenue reduction like a normal refund by debiting revenues and crediting refund account.

Positions

FPL's position is that they are refunding the rates back to the customer because of the rate reduction by the commission in 1990 and that part of that 65 cent rate roll back included excess deferred taxes, which were collected at 46%. The IRS believes that the refund is a subsequent event taking place then (1990) and forward, not a result of a refund flowing back to customer. FPL still contends that the excess deferred tax piece in the rate reduction belongs to prior years.

FPL believes that they are entitled to a Section 1341 deduction.

A

In 1990 the company started to take the Section 1341 credit on the tax return. Because of the dispute, the company rather than booking a refund booked a deferred income tax to offset the deduction in the current tax year. The journal entry would be debit deferred tax expense (410) and credit accumulated deferred income taxes (283). The credits claimed by the company total $11,777,802 for 1988 through 1992.

In order for staff to determine that this is the only litigation item for which the company is recording deferred tax, staff selected the month of June 98 to review the deferred tax issues booked. ~~There did not appear to be any other litigation items in the month of June 98 deferred tax accounts.~~ This is on WP no. 54-3. There was another litigation item on the FPL report. See 54-8.

4. Issues settled with the IRS in the last five years.

The staff requested a list of issues settled with the IRS in the past five years. The company provided us with the revenue agent report adjustments for FPL company for 1988 through 1992. WP 54-9 Staff selected certain issues to be explained and to provide IRS correspondence regarding these issues. These follow below.

B

A. 1992 Item. Repairs Nuclear Plant

FPL had repairs to the St. Lucie Nuclear Plant. They believed that some of these repairs should not have been capitalized. FPL got about 50% of the amount they requested in settlement.

A

There was no litigation and no appeals process. The revenue agents write up and adjustment report shows a decrease to income of $10,899,887 (54-4/1)

B. 1991 Item. Accrued Vacation Pay

This was a correction of an error. Prior to 1987 the IRS allowed 8-1/2 months of the following year vacation pay deduction. In 1987 the law changed and only allowed 2-1/2 months of future vacation pay deduction. FPL made an error in calculating the deduction in 1988. 1991 was the final correcting calculation. This adjustment increased 1988 taxable income in the amount of $3,111,283. The revenue agent write up and adjustments also decreased taxable income in 1989 in the amount of $630,268 and decreased income for $4,411,878 in 1990 and 1991. The decrease is due to a section 481 adjustment made by FPL which allows the phase in of a change in tax law over a four year period. The IRS's adjustment for the 1988 error also took into account the four year phase-in by FPL. The total amount for this adjustment was made in 1988 and the next four years were not necessary. Therefore, the decrease in income for the following three years. (54-4/2.)

1988 by the IRS

C. 1990 Item. Other Income - CIAC

FPL says this was a correction of presentation of CIAC on the tax return. FPL recorded certain government reimbursables as revenue which FPL says are non taxable and recorded items in the wrong place. Another part of the adjustment was FPL was claiming that replacement of overhead lines to underground lines was not taxable CIAC. These were tariffed items because they were already in place. The IRS said it was CIAC and taxable. There were a few other minor adjustments to CIAC. The net effect in the revenue agents write up and adjustment shows an increase to income of $4,984,307. (WP 54-4/3.)

D. 1989 item. Other Income . Customer Deposits

Prior to 1990 customer deposits were considered income. This was reversed and taken as a reduction to income over six years. In 1989 according to the revenue agents write up, the adjustment decreased taxable income by $2,660,618. (54-4/4.)

5. Review of 1995, 1996 and 1997 FPL Company tax returns.

Staff reviewed the tax returns in particular to determine if they filed Form 8275, Disclosure Statement. The company filed this form in 1995 and 1997.

In 1995 they disclosed that they were making and IRC Section 1341 adjustment in the amount of $3,210,275 for a refund of excess deferred taxes to customers. This is discussed above.

The second disclosure was that the taxpayer deducted accrued vacation pay on 12/31/95 which includes amounts deducted under IRC Section 83(h).

A

According to the company, the IRS allows a deduction for accrued expense for vacation pay if paid before March 15 of the following year. FPL also says if the company signs a letter of intent or make a bond payment, they can also deduct vacation pay. That is what the company did for 1988 through 1992. The IRS took the position that they were not allowed make a bond payment and passed a law in 1998 to that effect. FPL started making adjustments in 4th quarter of 1998 to start picking up additional expense. FPL further stated that they disclosed this on their return because in prior years things that the company did in the past were correct, but now the IRS is taking the position that past items are not necessarily correct.

In 1997 The company disclosed that they were making and IRC Section 1341 adjustment in the amount of $3,076,983. This is discussed above.

They also disclosed that they excluded from income a net adjustment of $56,000 for over recovered fuel charged in accordance with Houston Industries v. U.S. 32 Fed CI202-94-2 USTC50526. The company explained that the tax court ruled over recoveries are not taxable currently. However, expenses can be deducted if in under recovery position.

The company stated that they not recording any interest for tax deficiencies disclosed about vacation pay and over recoveries. The company is recording deferred taxes for the Section 1341 adjustment.

B

6. Review of Internal Audits

The internal audit of Business Meals, September, 1998, determined that when excluding 50% of business meal expenses for tax purposes, the company double counted capital meals, resulting in an overstatement of FPL's taxable income and tax liability. One report used by corporate tax to determine taxable income included both capital meals and expense meals. The other report used included only capital meals. The people who calculated taxes added both reports together and were not made aware that the capital meals were included in the first report in 1992. Therefore, capital meals were double counted for the taxable income from 1992 through 1996.

The double counting of capital meals was calculated to be $2.7 million for the years 1993 through 1996. This would have a favorable tax effect of $435,000. The internal audit stated that corporate will provide an adjustment to the IRS for the inclusion in the current review. As the 1997 tax return was not submitted yet, it will reflect the proper adjustment. WP 9.

A

When reviewing the company June 98 accrual - Schedule M deferred tax report, staff noted a deferred tax beginning balance in Account 282 called "TTC Transition Depreciation Adjustment". This sounded like one of the refund claim issues that FPL is in litigation with the IRS. (54-5)

Company personnel stated that this does relate to the Transitional Rules Depreciation litigation. See C&D explained on page 2. The company explained that beginning in 1997 the company booked tax depreciation expense based on ACRS for the new items or upgrades purchased or constructed to meet their franchise requirements the company claims come under the Transitional Rules.

The tax depreciation calculated in 1997 was based on ACRS for vintage years 1987, 88, 89 and 90 (the years the company claims the franchise agreements constitute a binding agreement and the transitional rules says ACRS OK.) This is also done for 1998. The company explained that prior to 1997 the tax depreciation was based on MACRS which in effect was booking tax depreciation as if the franchise agreement were not binding. The company said the first month booked deferred taxes associated with the 1996 tax return was Dec 97.

The company does include a beginning deferred tax balance in account 282 in their June 98 accrual schedule M deferred tax summary report of $4,183,905. Thus, they are accruing deferred tax for another litigation item.

COMPANY: FPL
TITLE: DEFERRED TAXES
PERIOD: YEAR-END 97
DATE: OCTOBER 26, 1998
AUDITOR: RKY

RW 10/28/98

WPNO. 54-3

A

Staff asked the company to explain how they booked the deferred taxes for their Section 1341 litigation explained in wp 54-1. The company gave us the example on WP 54-3/1 and 54-3/2.

Staff reviewed FPL's tax computation report for June 98 (book to tax income reconciliation). This is on WP 54-3/3. The objective was to determine if there were any items that were litigation or aggressive tax items creating timing differences which would cause a deferred tax entry.

Staff compared the topics on the June 98 book to tax income reconciliation topics with the topics on the M-1 schedules on the 1995, 95 and 97 tax returns. There was one item on the June 98 company book to tax reconciliation that wasn't on the tax returns. That was Pension Capitalized. The company explained that the item was netted with Pension SFAS 87 in prior years. This not one of the items in litigation or an aggressive stand.

Staff then compared the June 98 book to tax reconciliation with FPL June 98 Schedule M deferred tax summary report, 54-3/4. This report besides including Section 1341 deferred taxes also includes an item called ITC Transitional Depreciation Adjustment. When asked, the company stated that they forgot about this one and apologized. The explanation is on WP 54-1, pg 6.

As a final step, staff recalculated the deferred tax provision for the month of June 98 for random topics. The recalculations are on WP 54-3/5. Staff did this to learn how the company records these deferred taxes.

54-3

FLORIDA POWER & LIGHT
ACUFILE TAX SYSTEM
JUN98: ACCRUAL - ATL/BTL TAX COMPUTATION REPORT

Dale

TIME: 98JUN
ABOVE THE LINE:

	FPL - FEDERAL	FPL - STATE
PRETAX BOOK INCOME	111,931,928	111,931,928
PERMANENT DIFFERENCES:		
PLUS: ADDBACKS		
BUSINESS MEALS (1995, 1996 1997) (A)	195,716	195,716
TOTAL ADDBACKS	195,716	195,716
LESS: DEDUCTS		
LITIGAT MARTIN EQUITY	(91,499)	(91,499)
LITIGAT TP3 EQUITY	(436,713)	(436,713)
LITIGAT TP4 EQUITY	(289,196)	(289,196)
BOOK DEPRECIATION PERM (G)	(1,987,477)	(1,986,714)
TOTAL DEDUCTS	(2,804,885)	(2,804,122)
TOTAL PERMANENT DIFFERENCES	3,000,601	2,999,838
ULTIMATELY TAXABLE INCOME	114,932,529	114,931,766
NORMALIZED DIFFERENCES:		
PLUS: ADDBACKS		
DEF FRANCHISE FEE REV (1995 1996 1997)	(193,622)	(193,622)
ENVIRONMENTAL LIABILITY (1995, 1996, 1997)	30,953,193	30,953,193
SJRPP DEF INTEREST (1995 1996 1997)	56,435	56,435
SJRPP DECOMMISSIONING (1996 1997)	90,574	90,574
UNBILLED REVENUE FPSC	22,200,904	22,200,904
UNBILLED REVENUE FERC	996,766	996,766
DEF COMPENSATION (1995 1996 1997)	(6,752,107)	(6,752,107)
COST REDUCTION COSTS (1995 1996 1997)	(674,369)	(674,369)
INJURIES & DAMAGES (1995 1996 1997)	502,220	502,220
GAIN DISP PROP REV (1996 1997)	(75,575)	(75,575)
BAD DEBT EXPENSE (1995 1996 1997)	931,166	931,166
EARLY CAPACITY PAYMENTS (1995 1996 1997)	261,299	261,299
DECOMMISSIONING ACCRUAL (1995, 1996 1997)	7,054,371	7,054,371
DORMANT MATERIALS (1995 1996 1997)	114,477	114,477
STORM FUND ABOVE (1995 1996 1997) (D)	1,691,667	1,691,667
POST RETIREMENT BENEFITS (1995 1996 1997)	1,905,992	1,905,992
LEASE CANCELLATIONS Jensen Nonmeria	(148,520)	(148,520)
REGULATORY IMPACT	1,250,000	1,250,000
CAP GAIN EMISS ALLOW (1995 1997, 1996) (D)	33,407	33,407
NUC MAINT RESERVE 1996 1997	4,480,809	4,480,809
UNEARNED REVENUE SPRINT 1997	(16,667)	(16,667)
THERMOLAG DEF MATERIAL	(852,410)	(852,410)
METHOD LIFE CIAC 1996 1995 1997 (H)	2,625,170	2,625,170
PENSION CAPITALIZED Need to check	981,789	981,789
METHOD LIFE CPI 1995 1996 1997	427,245	427,245

(B)

(C) Included in one # on M-1 Schedule for 1995, 1996 & 1997

(H) Prior netted w/ Prodn STAS 57

543

FLORIDA POWER & LIGHT
ACUFILE TAX SYSTEM
JUN98: ACCRUAL - ATL/BTL TAX COMPUTATION REPORT

TIME: 98JUN

ABOVE THE LINE:	FPL - FEDERAL	FPL - STATE	
COST OF REMOVAL	(2,450,069)	(2,450,069)	
FOSSIL DISMANTLEMENT	1,413,509	1,413,509	
BOOK DEPREC VARIANCE	67,014,586	67,014,586	
DEF ITC INTEREST SYNCH	171,785	171,785	
NUCLEAR SPECIAL AMORT	2,500,000	2,500,000	
TOTAL ADDBACKS	136,494,025	136,494,025	
LESS: DEDUCTS			
WELFARE CAPITALIZED	226,834	226,834	
CITIGAT DEPR MARTIN	(45,439)	(45,439)	
LITIGAT MARTIN DEBT	(73,796)	(73,796)	
LITIGAT DEPR TP3	(206,166)	(206,166)	
LITIGAT TP3 DEBT	(339,965)	(339,965)	
LITIGAT DEPR TP4	(164,148)	(164,148)	
LITIGAT TP4 DEBT	(220,723)	(220,723)	
NUCLEAR FUEL INTEREST	85,450	85,450	
REPAIR ALLOWANCE	833,333	833,333	
REPAIR PROJECTS	812,388	812,388	
TAX BOOK DEPR DIFF	(11,959,892)	(10,582,870)	
NUCLEAR D & D	(1,394)	(1,394)	
COMPUTER SOFTWARE	3,711,448	3,711,448	
ORIMULSION	20,448,416	20,448,416	54-2/5
REAL PROP TAX	(13,791,667)	(13,791,667)	
AMORT MIT BANK RIGHTS	1,055,556	1,055,556	54-3/5
NUC THERMAL UPRATE	(344,221)	(344,221)	
DEF ECCR COSTS	(1,163,666)	(1,163,666)	
DEF FUEL COST FPSC	18,770,024	18,770,024	54-1/5
DEF FUEL COST FERC	28,216	28,216	
DEF ECRC COSTS	(758,718)	(758,718)	
GAIN LOSS REPC DEBT	(1,656,889)	(1,656,889)	
LOSS DISP PROP ADV	(1,111)	(1,111)	
PENSION SFAS 87	6,633,095	6,633,095	54-3/5
TOTAL DEDUCTS	21,896,965	23,273,987	
TOTAL NORMALIZED DIFFERENCES	114,597,061	113,220,039	
SUBTOTAL TAXABLE INCOME	229,529,590	228,151,805	
LESS: CURRENT STATE TAX	12,548,349	0	
TAXABLE INCOME	216,981,241	228,151,805	
APPORTIONMENT FACTOR	1.000000	1.000000	
TAXABLE INCOME	216,981,241	228,151,805	
STATUTORY INCOME TAX RATE	35.00%	5.50%	
TAX BEFORE CREDITS	75,943,434	12,548,349	
CURRENT TAX	75,943,434	12,548,349	

(J) Used to be recorded net of post retirement benefits on prior page.

(D) For tax - current deductible Book purposes - Capitalized when turned down by appeal - See surrebuttal report disclosure written by staff in last fuel audit.

FOR STUDY PURPOSES ONLY - NOT TO BE CONSTRUED AS MANAGEMENTS PROJECTIONS OF ACTUAL RESULTS

54-3/5

TIME: 98JUN
BELOW THE LINE:

	FPL - FEDERAL	FPL - STATE
PRETAX BOOK INCOME	39,041	39,041
PERMANENT DIFFERENCES:		
PLUS: ADDBACKS		
NUC FUND BLW TE INC	0	659,122
NUC_FUND_INC_CAP_GAIN	(24,743)	(24,743)
NUC_FUND_INC_PREF_DIV	3,779	3,779
NUC_FUND_INC_TAXABLE	102,550	102,550
PNLTY & OTHR NON DEDUCT	169,873	169,873
TOTAL ADDBACKS	251,459	910,581
LESS: DEDUCTS		
JEA ACQUISITN ADJ PERM	(171)	(171)
NUC FUND BLW PERM	749,527	749,527
EQUITY EARNINGS SUBS	499,580	499,580
TAX_EXEMPT_INT_INC	148,860	0
TOTAL DEDUCTS	1,397,796	1,248,936
TOTAL PERMANENT DIFFERENCES	(1,146,337)	(338,355)
ULTIMATELY TAXABLE INCOME	(1,107,296)	(299,314)
NORMALIZED DIFFERENCES:		
PLUS: ADDBACKS		
JEA ACQUISITION ADJUSTMENT	(171)	(171)
GAIN DISP PROP BLW	(71,561)	(71,561)
DECOMMISSIONING BELOW	1,130,633	1,130,633
STORM FUND BELOW	971,668	971,668
PRINECO CIAC BELOW	(16,856)	(16,856)
TX REFUND INT BELOW	(57,692)	(57,692)
TOTAL ADDBACKS	1,956,023	1,956,023
LESS: DEDUCTS		
LOSS DISP PROP BLW	(10,373)	(10,373)
TOTAL DEDUCTS	(10,373)	(10,373)
TOTAL NORMALIZED DIFFERENCES	1,968,396	1,968,396
SUBTOTAL TAXABLE INCOME	861,100	1,669,082
LESS: CURRENT STATE TAX	91,800	0

FOR STUDY PURPOSES ONLY: NOT TO BE CONSTRUED AS MANAGEMENT'S PROJECTIONS OF ACTUAL RESULTS

1988 - 1992 RAR ADJUSTMENTS
FPL

Form 4549-B (Rev. October 1976)	Department of the Treasury - Internal Revenue Service INCOME TAX COMPUTATION CHANGES	Return Form No. 1120

Name and Address of Taxpayer
FPL GROUP, INC. & SUBSIDIARIES
FPL GROUP, INC. - TAX DEPT.
P.O. BOX 14000
JUNO BEACH FL 33408

Social Security or Employer Identification Number
59-2449419

Adjustments to Income - ENTITY DETAIL		Year: 0012	Year: 0912	Year: 9012
FLORIDA POWER & LIGHT COMPANY				
A. DEPRECIATION - AFUDC ST. LUCIE #1	-0001	423,847.00	254,358.00	
B. AMORTIZATION - CAPITALIZED C.P.I.	-0002	(459,573.00)	(459,573.00)	(459,573.00)
C. DEPRECIATION - 1985/1986 CIAC PROPERTY	-0003	(716,000.00)	(532,758.00)	
D. DEPRECIATION - 1987 CIAC PROPERTY	-0004	(80,758.00)	(72,675.00)	
E. DEPR. - 1987 CAPITALIZED INTEREST/NUCLEAR FU	-0005	(832,057.00)	(499,234.00)	(299,541.00)
F. DEPRECIATION - 1987 INTEREST RATE CIAC 2638	-0007	48,045.00	43,241.00	
G. DEPRECIATION - PRE-1986 CIAC PROPERTY	-0008	(533,827.00)		
H. DEPRECIATION - 1986 ITC TRANSITION PROPERTY	-0009	(259,138.00)	(238,346.00)	
I. DEPRECIATION - 1986 ITC REGULAR PROPERTY	-0010	(71,814.00)	(63,834.00)	
J. DEPRECIATION - NUCLEAR FUEL - 1986 OWNERS	-0011	(9,782,625.00)		
K. DEPRECIATION - AFUDC ST. LUCIE #1	-0016	1,052,905.00	1,684,776.00	
L. OTHER INCOME - CUSTOMER DEPOSITS 54-4/4	-0017	(5,324,303.00)	(2,660,610.00)	(2,660,615.00)
M. DEPRECIATION - AFUDC ST. LUCIE #1	-0026		224,358.00	358,973.00
N. TAXES - ACCRUED PROPERTY TAXES	-0042		197,864.00	417,793.00
O. OTHER INCOME - CIAC 54-4/3	-0053	(3,929,356.00)	3,115,647.00	4,984,307.00
P. DEPRECIATION - CIAC	-0056	463,691.00	983,608.00	1,870,512.00
Q. OTHER INCOME - CIAC	-0057	(2,214,771.00)	(1,323,358.00)	(1,587,353.00)
R. OTHER INCOME - AMORTIZATION LOSS PORTION UNIT	-0061	(1,336,753.00)		
S. OTHER EXPENSES - REMOVAL COSTS	-0064	642,600.00	3,720,043.00	2,588,122.00
T. DEPRECIATION - REMOVAL COSTS	-0067	(24,898.00)	(185,891.00)	(488,211.00)
U. OTHER DEDUCTIONS - SJRPP DECOMMISSION COSTS	-0070		1,691,537.00	1,691,537.00
V. DEPRECIATION	-0079			(9,792,549.00)
W. CLOSE - ACCRUED VACATION PAY	-0077	3,111,283.00	(630,258.00)	(1,411,878.00)
X. RESEARCH AND DEVELOPMENT-REVISED	-0111	0.00	(1,115,774.00)	(15,059,186.00)
Y. TAXES	-0118	1,435,719.00	(143,875.00)	900,418.00
Z.				
TOTAL ADJUSTMENTS		(18,447,295.00)	6,690,246.00	(19,873,546.00)

Form CO-4549-B

MP 54-4

1988-1992 RAR Adjustments
FPL

Page 31 of ___

Form [illegible] (Rev. October 19[illegible])	Department of the Treasury - Internal Revenue Service [illegible]	Return Form No. [illegible]

Name and Address of Taxpayer
FPL GROUP, INC. & SUBSIDIARIES
FPL GROUP, INC. - TAX DEPT.
P.O. BOX [illegible]
[illegible] FL [illegible]

Social Security or Employer Identification Number
[illegible]

Adjustments to Income - ENTITY DETAIL		Year: [illegible]	Year: [illegible]	Year:
FLORIDA POWER & LIGHT COMPANY				
A. [illegible] - CAPITALIZED C.P.I.	[illegible]	(103,978.00)		
B. [illegible] - 1987 CAPITALIZED [illegible]	[illegible]	(299,541.00)		
C. DEPRECIATION - AFUDC ST. LUCIE II	[illegible]	216,384.00		
D. DEPRECIATION - AFUDC ST. LUCIE II	[illegible]		129,220.00	
E. [illegible]	[illegible]	1,257,552.00	1,019,344.00	
F. REPAIRS NUCLEAR PLANT - [illegible] SY-4 / 1	[illegible]		(10,899,997.00)	
G. REPAIRS [illegible] - [illegible]	[illegible]		1,192,638.00	
H. REPAIRS [illegible] - [illegible]	[illegible]		(238,535.00)	
I. OTHER INCOME - CIAC SY-4 / 3	[illegible]	2,202,368.00	3,308,655.00	
J. DEPRECIATION - CIAC	[illegible]	1,111,200.00	(1,079,073.00)	
K. OTHER INCOME - CIAC	[illegible]	(2,170,014.00)	(2,885,502.00)	
L. OTHER EXPENSES - [illegible]	[illegible]		28,132.00	
M. OTHER EXPENSES - [illegible] COSTS	[illegible]	3,018,053.00	3,080,055.00	
N. DEPRECIATION - [illegible] COSTS	[illegible]	(307,528.00)	(798,691.00)	
O. DEPRECIATION	[illegible]	(3,155,465.00)	913,178.00	
P. CLAIM - ACCRUED VACATION PAY SY-4 / 2	[illegible]	(5,911,079.00)		
Q. [illegible] SCHEDULE M - VACATION PAY	[illegible]		28,288,457.00	
R. [illegible]	[illegible]		7,286,227.00	
S. [illegible]	[illegible]		10,858.00	
T. DEPRECIATION-REVISED	[illegible]		540,594.00	
U. REPAIRS	[illegible]		(612,852.00)	
V. RESEARCH AND DEVELOPMENT-REVISED	[illegible]	(1,074,686.00)	(1,326,675.00)	
W. TAXES	[illegible]	285,175.00	(1,028,071.00)	
X.				
Y.				
Z.				
TOTAL ADJUSTMENTS		(7,077,802.00)	28,967,805.00	0.00

(2)

Form [illegible]

Confidential

SY-4

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit 5701-51
Name Of Taxpayer	FLORIDA POWER & LIGHT COMPANY	Year/Period 1992

SUMMARY OF ADJUSTMENTS

REPAIRS:

YEAR	PER AMENDED RETURN	ALLOWED	INCREASE/(DECREASE) ADJUSTMENT TO INCOME
9212	$21,018,712	$10,899,887	($10,899,887)

54-4 P2

ISSUE: T/P reclassified certain expenditures at St. Lucie & Turkey Point plants as repairs on its 1992 amended return. Should these be allowed as repairs deductible as current expenses?

STATEMENT OF FACTS:

The T/P in its 1992 amended Tax return filed on 12/16/93, claimed for refund for reclassifying $21,018,712 expenditures, as repairs for the integrated nuclear units at St. Lucie and Turkey Point.

The following explanation is taken from the amended return description:

"The refund claimed results from an ordinary and necessary business expense under Section 162 and Regulation §1.162-4 in the amount of $21,018,712 for repairs made to nuclear electric generating units operated by taxpayer at St. Lucie and Turkey Point. Consistent with this treatment we have also deducted additional interest expense of $50,445 (as a result of construction period interest mistakenly capitalized) and reduced the depreciation expense by $578,802 for the 1992 taxable year.

The amount claimed represents the repair expenses incurred in 1992 for repairing and replacing existing components and equipment which are integral parts of nuclear electric generating units, including, but not limited to the following: steam generator components, turbine components, pumps and motors,. electric control and monitoring devices and miscellaneous components related to the operation of the nuclear reactor unit.

The useful lives of the taxpayer's nuclear facilities will not be prolonged by the repairs claimed herein. The repairs also will not materially add to the value of the nuclear facilities when compared to their respective values prior to the condition requiring the repairs. As a result of the claimed repair expenditures the expected power production and operating efficiencies at taxpayers nuclear facilities will not increase beyond the original specifications of the plants when first placed in service.

Accordingly, the function value of the nuclear facilities did not increase as a result of the repairs. The repairs will merely return the nuclear facilities to the originally intended ordinary operating condition and

confidential

(1) 1 (40)

IND 54-4

efficiency. Thus, since the facilities will not operate on a more efficient or larger scale, nor will they thereafter be suitable for new or additional uses, the claimed expenditures are currently deductible as repair expenses."

Subsequently, the Engineer submitted a FORM 5701 # 51 dt. 8-29-94, along with an 886-A "Explanation of items" disallowing certain reclassification of expenditures by T/P as Repairs.

Following that, the Engineer received the T/P's response dt. 12/7/94 on 1/20/95 and reviewed the arguments put forward by the T/P's Representatives.

The T/P brought up "unique" reasonings and wanted the Internal Revenue Service to consider each Plant as a "Unit of Property" and wants to apply the "Placed-in-Service" and "Investment Tax Credit" Code and Regulation Sections, Revenue Rulings and Court cases.

The Engineer disagreed with the T/P's position and the reasons were set forth in a write-up that was submitted to the T/P on 2/22/95.

STATEMENT OF LAW:

Rev. Rul 88-57, 1988-2, CB 36
Rev. Rul. 59-380, 1959-2 C B. 87
Rev. Rul. 55-252, 1955-1 C. B. 319.
Sec. 1.162-4 of the Regulations : Repairs
Sec. 263(a) of the I.R.C. : Capital expenditures
Sec. 1.263(a)-1 of the Regulations: Capital expenditures
Sec. 1.263(a)-2 of the Regulations: Examples of Capital expenditures
Bruin Coal Co. 1BTA 83, Dec. 45 (Acq.)
ILLINOIS MERCHANTS TRUST CO v. Commissioner, 4 B.T.A. 103, 106, acq., V-2, C.B. 2 (1926)
Phillips and Easton Supply Company v. Commissioner, 20 TC, 20 TC 455, (1953)
INDOPCO, Inc., v. Comm 92-1 USTC P50,113, Supreme Court of the United States, 90-1278, 2/26/92, 112 SCt 1039; affg. CA-3, 90-2 USTC P50,571, 918 F.2d 426.
Electric Energy, Inc., v. United States, 87-2 USTC P9587, US-CL-CT (1987)
Lincoln Savings v. U.S., 71-1 USTC P9476, 405, at 354
Claussner Hosiery Company v. Commissioner, Docket No. 18624, 9 TCM 891,
Union Pacific R. R. Co. v. United States 99 U.S. 402, page 420:
Accurate Tool Co., Inc. v. Commissioner, Docket Nos. 8802, 10029, 10097, 10 TCM 354, (1951)
Transport Manufacturing & Equipment Co v. Commissioner, 70-2 USTC P9627, 434 F2d 373, 377-78, 8th Circuit (1970)
Hudlow et al. v. Commissioner, 30 TCM 894, TC Memo. 1971-218, (1971)
Oberman Manufacturing Co., 47 T. C. 471, 483 (1967),

Plainfield-Union Water Co. [Dec. 25,740], 39 T. C. 333, 337-338 (1962).
Almac's Inc. v. Commissioner 20 TCM 56, TC Memo. (1961)
Idaho Power Co v. Commissioner, 74-2 USTC P9521, No. 73-263, 418 US 1, 94 SCt 2757, 6/24/74, Rev'g CA-9, 73-1 USTC P9367, 477 F. 2d 688, which had rev'd 29 TCM 383, Dec. 30,053(M), T. C. Memo. 1970-83
Home News Publishing Co. v. Commissioner, 18 B.T.A. 1008 (1930)
United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968)
Jason L. Honigman 55 T. C. 1067, 1081 (1971)
J.W. Evans, 40 TCM 65, Dec. 36,866(M), TC Memo 1980-103
Harman Coal Corp., 52-2 USTC 9487 (CA-4)
Lytle et al., 21 BTA 1423, Dec. 6673 (Acq.)
Marsh Fork Coal Co. v. Lucas 42 F2d 83, 8AFTR 11046 (4 Cir. 1930)
Simmons & Hammond Mfg. Co. 1 BTA 803

TAXPAYER'S POSITION:

Taxpayer is now in agreement with this adjustment.

ENGINEER'S POSITION:

The Engineer reviewed the 44 work orders that were submitted by the T/P for the claim and disagrees with the T/P on the 23 work orders. The Engineer consider these 23 as "capital", see EXHIBIT A, and the reasons are discussed below:

1. WO/ER/LOC: 1716/70/915: The Engineer reviewed the Work Order and found that it consisted of 4 pages and only page 1 and 2 were submitted.

   This ER is a re-estimate to capture actual costs of the 1991 Emergency ER. The costs are for the installation of QS P D S Plasma Display Reactor Control Sytem during the 1991 St. Lucie Unit 1 Outage.

   From the limited information submitted the Engineer concludes that a new display system was installed and there is no indication when the prior units were replaced. If they are replaced with a frequency of less than one year, then the amount is considered as repair.

2. WO/ER/LOC: 2786/70/915: This Work Order for $49.114 million was initiated on 6/15/93 and final authorization was given on 7/3/93 and the expected completion date on the project is 12-31-96.

   The Work Order deals with procuring two new Steam Generators for Unit # 1 at St. Lucie Plant to be placed in service during the last part of 1996.

   Under Description, a note indicates that "the payments for two new steam generators for Unit #1. Further, according to the "Purpose and Necessity",

" there has been continued corrosion of the St. Lucie Unit # 1 steam generator tubes that resulted in 12.7% of steam generator "A" and 8.6% of steam generator tubes being plugged and removed from service."

There is also another note: "The original authorization was for $12.8 million for preliminary Engineering efforts."

From the description the expenditures are for new capital assets and are a replacement for "corroded" units. Further, these expenditures are for assets that will go into Service in 1996 and the payment appear to be advance payments on items ordered. In addition, it was found that this Work Order was prepared in 1993.

3. WO/ER/LOC/2787/70/915: This Work Order is related to the above one WO/ER/LOC/2786/70/915 with a completion date of 6-30-98, which was initiated on 6/15/93, for a total cost of $120.886 million. This project is part of the approved 1993 Capital Budget.

   Under "Description", it states - "Construction, Engineering, Procurement, removal and disposal costs for the replacement of the existing steam generators on PSL Unit # 1".

   The costs are for procuring a capital asset and does not even appear to be a 1992 expenditure. Further the assets will not be placed in service until 1998.

4. WO/ER/LOC/3160/70/915: A review of the Work Order indicates that the expenditure appears to be to replace 1A Diesel Oil Transfer Line I-2"-DO-13 with a 2" schedule 80 carbon steel pipe inside a 3" carbon steel guard pipe (with sacrificial anodes) at St. LUCIE Unit #1.

   Further, the description indicates that the existing line is degraded and leaking. The replacement is a betterment per Sec. 263 of the IRC.

5. WO/ER/LOC/2404/70/910.009: The Work order is for replacement of 56 incore detectors in St. Lucie Plant Unit 2 reactor. The description further indicate that the incore instrumentation system is used by the operators to determine the local power condition within the core. The information obtained from this system is used to take action necessary to control power within the reactor core to prevent possible fuel damage. Further, the description indicates that "the detectors currently installed have reached the end of their service life.

It is unclear from the Work Order whether the items were installed in 1992. The expenditures are for replacement of capital assets, which

reached the end of their useful lives, and therefore are capital expenditures.

6. WO/ER/LOC/2466/70/910.009: The Work Order is for replacement of two Heated Junction Thermo Couple assemblies in Unit # 2 QS PSDS system. The probes supply reactor temperature parameters to operators and are required to be functional by technical specifications.

   The expenditure is for a capital asset that are required to be "operational". Therefore, it appears that the prior Heated Junction thermocouples have reached their end of useful lives and any replacements should be considered as Capital expenditures.

   Further, there is no evidence that the item was installed in 1992.

7. WO/ER/LOC/2500/70/910.009: The Work Order pertains to Control Element assemblies for Unit 2, 1992 Outage. The project authorizes CE/ABB to perform Eddy current testing on 35 unit 2 CEA's to examine for cracking or unusual wear. This testing will be accomplished on CEA's stored in Unit 2 spent fuel pool. This authorization is also for replacement of 35 new CEA's.

   Further, under the "Purpose & Necessity", the following description could be found:

   "CEA's are approaching design lifetime of 10 years. Replacement after such time is an FSAR requirement. Installation and removal will be accomplished as part of normal refueling and CEA shuffling. Therefore, no estimate for labor is provided, nor will any amount be charged against this work order."

   From the description it appears that the assets being replaced reached their end of design life, and it is also uncertain whether the assets were placed-in-service in 1992.

8. WO/ER/LOC/2925/70/910.009: The Work Order pertains to replacement of #2B Intake Cooling water pump with modified pump in St. Lucie Unit 2, (Byron Jackson pump model 37KXL, 14,500 GPM, 900 RPM, pump style- single stage vertical).

   Under the "Purpose & Necessity", - "The replacement with the self lubrication modification has improved reliability by providing a more reliable lube water flow to the bearings using the process fluid (sea water). The self lube modification will eliminate the chance for catastrophic failure of the intake cooling water pump bearings due to plugged lube water lines.

   From the description it appears that the assets that are being replaced

are a "betterment" and of "better design".

9. WO/ER/LOC/2926/70/910.009: This Work Order is similar to the one above and pertains to replacement of #2C Intake Cooling water pump with modified pump in St. Lucie Unit 2, (Byron Jackson pump model 37KXL, 14,500 GPM, 900 RPM, pump style- single stage vertical).

   Under the "Purpose & Necessity", this has exactly same description as above - "The replacement with the self lubrication modification has improved reliability by providing a more reliable lube water flow to the bearings using the process fluid (sea water). The self lube modification will eliminate the chance for catastrophic failure of the intake cooling water pump bearings due to plugged lube water lines. The assets that are being installed are a "betterment" and "better design" and therefore are capital assets.

10. WO/ER/LOC/2353/70/929.009: This Work Order pertains to removal and installation of approximately 2,200 LF of nine (9) gauge security fencing, West perimeter zones: PZ12-PZ18, North perimeter: Zone Pz-26.

    Under the "Purpose & Necessity" -"Replacement needed due to corrosion of existing fencing. Project will help to complete the total replacement of all security fencing started in 1990.

    The previous fence corroded and the replacement fence is a planned replacement of the entire fence that started in 1990 and is a capital asset.

11. WO/ER/LOC/1261/70/914: This Work Order concerns with replacement of Seven (7) obsolete H & W Recorders (emphasis added), as per PCM 90294 on Unit 3. Recorders will be replaced in the following systems: Main steam, turbine lube oil, turbine system, circulating water and generator system.

    Under the "Purpose & Necessity" - "At the present time, the installed recorders are obsolete and parts are no longer available. This effects the following: (1) Equipment out of service long, (2) number of PWO's awaiting parts, (3) control room green tags, (4) number of trouble and breakdown plant work orders to H & W recorders.

    The recorders are obsolete and have been breaking down and the new recorders are advance type and therefore should be capitalized.

12. WO/ER/LOC/1265/70/914: This Work Order has the same description as the above one except this is for Unit 4. Recorders will be replaced in the following systems: Main steam, turbine lube oil, turbine system, circulating water and generator system.

    Under the "Purpose & Necessity" - "At the present time, the installed

recorders are obsolete and parts are no longer available. This effects the following: (1) Equipment out of service long, (2) number of PWO's awaiting parts, (3) control room green tags, (4) number of trouble and breakdown plant work orders to H & W recorders.

From the description, these are "capital" assets and of a better design and less prone for breakdowns.

13. WO/ER/LOC/2250/70/914: It deals with 3 E Motor Control Center replacement. such as purchase new MCC, install new MCC, reconnect cables, remove temporary power, seal conduit, paint, cleanup and perform startup testing.

The present 3 E Motor Control Center is rusted to the extent of structural degradation. The rust and corrosion has been attributed to the salty environment in the intake area.

The asset that is being replaced is rusted and corroded due to its age and environment and therefore are capital. It is uncertain whether the work is completed in 1992.

14. WO/ER/LOC/2324/70/914: This deals with PCM 88-490 recorder change out for Unit 3; essentially replacing seven obsolete control room recorders in Unit 3, with new Westronics model 2100.

The old L & N recorders TR-1417, PR-6306A, 6306B, RAR-6311A, 6311B, LR-6308A, 6308B, will be replaced with reliable Tracor Westronics digital recorders. The new recorders are state of the art.

The replacement recorders are a betterment. There is no indication that these were placed-in-service in 1992.

15. WO/ER/LOC/2334/70/914: It deals with replacing existing hydrogen analyzer and associated H2, N2 supply lines with new dissolved hydrogen analyzer and new supply lines.

According to the description - there will be an improvement in the reliability and also reduction in excessive maintenance manhours and downtime associated with the current dissolved H2 analyzer. The requirements of NUREG 0737 and NRC follow-up 84570 will be met. There will also be an improvement in the Pass reliability as committed in response to QA audit finding - QAO-PTN-87-863.

The replacements are of better design and will cut down the maintenance manhours and down time. It is not certain whether the project was completed in 1922.

16. WO/ER/LOC/2381/70/914: It deals with replacing Unit 3 A steam generator

feedwater pump. The new pump will have casing fabricated with an upgraded material (emphasis added), and will have improved impeller and thrust nut locking devices.

The replacement of the pump casing will preclude defects such as pin hole leaks and cracks which were experienced with the existing casing. The replacement of the impeller and thrust nut locking devices with an improved design will improve pump reliability. These changes have previously been performed on feedwater pumps 4A, 4B & 3B.

The replacement pump casing has upgraded material and would require less maintenance. It is not certain whether the project was completed in 1992.

17. WO/ER/LOC/2784/70/914: This Work Order deals with replacement of Unit 3 core exit thermocouple seals with seals of an upgraded design.

The existing core exit thermocouple nozzles on the reactor vessel closure head has two primary pressure boundary "Conoseal" metal seals that must be disassembled at each refueling outage. The Conoseal installation techniques and surface finish are extremely critical. In recent years Turkey Point has had several leaks at the Conoseal upon returning to service after an outage. The problems with the currently installed Conoseal design are attributed to the difficulty in assembling the seal and the degradation of the sealing surfaces which has occurred during the many times they have been disassembled and reassembled.

The new design eliminates the lower Conoseal joint and the upper seal is replaced with a softer graphite seal. The design of the upper graphite seal allows for a one-joint disassembly each outage, resulting in significant time and radiation exposure savings.

The new assets are of new design and expect to result in significant time savings and are less health hazard and therefore are capital assets. It is not certain whether the project was completed in 1992.

18. WO/ER/LOC/2798/70/914: This has the same description as the above except for the unit 4.

It is not certain whether the project was completed in 1992.

19. WO/ER/LOC/2885/70/914: This Work Order is for performing required Engineering, tag cable, determ cables, pull back cables into manholes remove MCC from intake, repair concrete pad as required, purchase new MCC, install new MCC, reconnect cables, remove temporary power, seal conduits, paint, cleanup and perform startup testing.

The present 4 E MCC is rusted and corroded to the extent of structural

to replace the valves with new ones recently received, during the outage schedule as opposed to waiting for refurbishment of the existing ones. The old ones will be sent out for refurbishment after this outage and returned to inventory as spares for subsequent outage swap-outs.

This W.O. is dated 12-7-92 and therefore it is uncertain whether the work was completed in 1992.

DISCUSSION OF LAW:

1. Sec. 1.162-4 Repairs:

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

2. Section 168(a) of the I. R. C. provides generally that the depreciation deduction permitted by section 167(a) for any tangible property shall be determined by using (1) the applicable depreciation method, (2) the applicable recovery period, and (3) the applicable convention. Under the classifications of property set forth in section 168(e)(1), the recovery period for Utility property is 20 years, which has a class life of 25 or more years.

3. Sec. 263(a) General Rule. - No deductions shall be allowed for--

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to--

* * * *

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

4. Sec. 1.263(a)-1 of the Regulations state:

"Except as otherwise provided in Chapter 1 of the Code, no deduction shall be allowed for -

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate,

or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which allowance is or has been made in the form of a deduction for depreciation, amortization or depletion."

5. Further, Sec. 1.263(a)-2 of the Regulations give several examples of capital expenditures. Sec. 1.263(a)-(2)(a) states:

"The cost of acquisition, construction or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."

Section 263 of the IRC was given a lot of weight by the Court in the case of Idaho Power Co v. Commissioner, 74-2 USTC P9521, and the Court's observations regarding Sec. 263 are quoted below:

a. The presence of S263(a)(1) in the Code is of significance. Its literal language denies a deduction for "[a]ny amount paid out" for construction or permanent improvement of facilities.

b. The purpose of S263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing. The regulations state that the capital expenditures to which S263(a) extends include the "cost of acquisition, construction, or erection of buildings." Treas. Reg. S1.263(a)-2(a). This manifests an administrative understanding that for purposes of S263(a)(1), "amount paid out" equates with "cost incurred." The Internal Revenue Service for some time has taken the position that construction-related depreciation is to be capitalized. Rev. Rul. 59-380, 1959-2 C B. 87; Rev. Rul. 55-252, 1955-1 C. B. 319.

There are also several other Court cases on the point:

J.W. Evans, 40 TCM 65, Dec. 36,866(M), TC Memo 1980-103
Lytle et al., 21 BTA 1423, Dec. 6673 (Acq.)
Simmons & Hammond Mfg. Co. 1 BTA 803, Dec. 296

(11)

6. Revenue Ruling 88-57, 1988-2 CB 36, discusses about a corporation in the railroad business, established a program for major cyclical rehabilitation of freight train cars. Under this program, taxpayer transfers its freight-train cars to its shops after a predetermined amount of service and restores them to an efficient operating condition. This rehabilitation usually occurs after approximately 8 to 10 years of continuous use. At this time the freight-train car typically has a value of $8,000. Following rehabilitation, the car's value increases to approximately $30,000. The rehabilitation includes a complete disassembly, inspection, and reconditioning and/or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. Modifications are made to the car in order to upgrade various components to the latest engineering standards. The freight-train car essentially is stripped to the frame, with all of its structural components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight-train car are replaced or are sandblasted and repainted. New wheels typically are installed on the car. All the remaining components of the car are restored before they are reassembled. After this procedure, cars fulfill the requirements for "Reconditioned" status under the terms of the FRA Railroad Freight Car Safety Standards. Reconditioning each car requires from $8,000 to $15,000 for materials and from 80 to 150 hours of labor. The current cost of a new freight-train car is approximately $45,000.

   The taxpayer's program for major rehabilitation of its freight-train cars to restore them to efficient operating condition is such a plan. Thus, under this test none of the expenditures are for incidental repairs and all the expenditures must be capitalized.

   The above Rev. Rul. held that Cyclical expenditures for major rehabilitations of railroad freight-train cars are capital expenditures under section 263(a) of the Code. It was also ruled that a change from treating cyclical expenditures for rehabilitations of railroad freight-train cars as repair and maintenance expenses to treating them as capital expenditures is a change in method of accounting to which sections 446 and 481 of the Code and the related regulations apply.

CASE LAW: The Courts distinguished what costs should be expensed and or capitalized over the years. Perhaps the first one pertains to Illinois Merchants Trust Co. Further, the Courts ruled that, an expenditure made for an item that is part of a general plan of rehabilitation, modernization, and improvement of the property must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair. United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968); Home News Publishing Co. v. Commissioner, 18 B.T.A. 1008 (1930).

Further, in deciding the question of repair expenses vis-a-vis capital

expenditures, the Courts looked at the purpose for which an expenditure is made in order to determine its nature. A repair expense is made merely to keep the property in an operating condition over its probable useful life; it does not add to the value of the property or appreciably prolong its life. In contrast, when work is performed to prolong the life of the property, increase its value, or make it adaptable to a different use, the cost of such work is a capital expenditure. Jason L. Honigman [Dec. 30,691], 55 T. C. 1067, 1081 (1971).

Thus, under applicable law, an expenditure to rehabilitate property must be capitalized rather than deducted as an expense if any of the following tests are satisfied: (1) the expenditure appreciably prolongs the useful life of the property; (2) the expenditure materially adds to the value of the property; or (3) the expenditure is part of a general plan of rehabilitation, modernization, and improvement of the property. A taxpayer must apply each of these tests before determining that an expenditure can be deducted as an expense.

Further, one treatise describes fixing the dividing line between capital expenditures and repairs as "an almost insoluble problem inasmuch as questions of degree are involved." 6 J. Mertens, Law of Federal Income Taxation S25.56, at 216 (Rev. 1985).

In determining the characterization of a particular item it is also necessary to ascertain the purpose for which the expenditure is made. If its purpose is merely to keep the property or a machine in efficient operating condition and is accordingly in the nature of a maintenance charge, it is ordinarily deductible. . . .

1. In the Appeal OF ILLINOIS MERCHANTS TRUST CO v. Commissioner, 4 B.T.A. 103, 106, acq., V-2, C.B. 2 (1926), the Court stated:

"In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are

additions to capital investment which should not be applied against current earnings."

2. Further in the Appeal of Simmons & Hammond Manufacturing Co., 1 B. T. A. 803, the Court held that expenses properly chargeable to capital account include those which are incurred in the original construction of the work and in the subsequent enlargement and improvement thereof, and quoted the following from Union Pacific R. R. Co. v. United States 99 U.S. 402, page 420:

"Theoretically, the expenses chargeable to earnings include the general expenses of keeping up the organization of the company, and all expenses incurred in operating the works and keeping them in good condition and repair; whilst expenses chargeable to capital include those which are incurred in the original construction of the works, and in the subsequent enlargement and improvement thereof."

3. In Accurate Tool Co., Inc. v. Commissioner, Docket Nos. 6802, 10029, 10097, 10 TCM 354, (1951), the Company was organized in 1941, and during the taxable years 1942 and 1943 was primarily engaged in the business of manufacturing pipe plugs, steel inserts, and wing nuts for United Aircraft.

The Commissioner disallowed * * * and * * * claimed by the T/P as expenses incurred in the purchase of perishable tools for the years 1942 and 1943, respectively. Commissioner introduced in evidence an itemized list of tools and dies purchased by petitioner in 1942 in the amount of * * * and of machinery purchased by petitioner in 1943 in the amount of * * *. Commissioner disallowed as expense deductions all of the above purchases for 1942, and * * * of the purchases in 1943 for the reason that they represented capital expenditures. The Court ruled that the T/P failed to prove that these items disallowed by Commissioner were not capital assets and, therefore, Government's determination was sustained.

4. In Lincoln Savings 71-1 USTC P9476, 405 U.S., at 354, the Supreme Court was asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under S162(a), as Lincoln Savings argued and the Court of Appeals had held, as capital expenditures under S263, as the Commissioner contended. The Court found that the "additional" premiums, the purpose of which was to provide FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, "serv[e] to create or enhance for Lincoln what is essentially a separate and distinct additional asset." and "[A]s an inevitable consequence," the Court concluded, "the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under S162(a)." Ibid.

5. In HOME NEWS PUBLISHING CO., v. COMM, 18 B.T.A. 1008 CCH Dec. 5791 the Court ruled that the expenditures made by the T/P, which were pursuant to a general plan of reconditioning and improving and altering the property as a whole to make it suitable for the T/P's purposes, were capital expenditures. See also H. S. Crocker Co., supra; Leedom & Worrall Co., 10 B. T. A. 825; Foer Wall Paper Co., 9 B. T. A. 377.

The T/P acquired the building in 1908 and to 1921 it was never occupied by the T/P, but was rented to tenants. Of the tenants, one used it for a garage. Another tenant used it for a cut-glass factory. Each of the tenants had an office in the building during the period of his occupancy.

After inspecting the building about the first part of 1921 the building inspector for the City of New Brunswick objected to its being occupied in the condition it was at that time. He had previously made objections to the condition of the building. He considered it was unsafe and wanted it made into a better structure than it was. He considered the wooden girders then supporting the second and third floors of the rear half of the building as unsafe and required that they be replaced with steel girders in order to make the building safe for occupancy.

The petitioner employed an architect to make designs for and supervise the replacement of the girders and other work that was done on the building. A steel structural engineer and contractor was engaged to install the steel girders. He installed them for the second and third floors of the rear half of the building and got the building ready for the reception of the wood floor joists on these steel girders. These girders were to support the floors and whatever was placed on them and were not needed to support any of the walls of the building. * *

* * * *

In connection with the replacement of the wooden girders certain carpenter work was necessary. A carpenter and contractor was engaged to do the work. In addition to this work this contractor also did other carpenter work on the front half of the building. This latter work consisted of installing a new glass front to the first floor of the building, laying floors in the front part of the building and repairing the walls, partitions and ceilings. * * *

* * * all of the work done on the front part of the building was necessary because of the ordinary wear and tear during its long life of perhaps fifty years, plus the damage resulting from its having been used as a garage. The building had not been repaired for several years. * * *

The wooden beams or girders that were removed had a useful life of 30 years, under the conditions to which they were subjected. The steel girders that were installed had an estimated useful life of 40 years. Irrespective of whether wooden girders were reinstalled or steel girders installed as was done, the materials furnished and the work done would have been necessary. * * *

As a result of the work done by the structural engineer and the carpenter, no floor space was added to the building nor was there a new roof put on. * * * * * * *

The work done on the building served to prolong its life and put it in condition for use by the petitioner for its publishing business.

The Court concluded that the expenditures were for replacements, alterations, improvements and additions they must be capitalized. Illinois Merchants Trust Co., Executor, 4 B. T. A. 103; H. S. Crocker Co., 15 B. T. A. 175.

6. In U.S. v. W. J. Wehrlis, 68-2 USTC P9575 (1968), U. S. Court of Appeals, 10th Circuit, No. 9723, 400 F2d 686, 9/11/68, the US Court of Appeals sent the case back to District Court for retrial, Reversing District Court decision, 67-2 USTC P9512, as it felt that certain costs should have been capital.

In 1957 Wehrli, the taxpayer, purchased an office building on two lots for * ** ** ** from an oil company, which continued to occupy the premises for approximately seven months after the sale. The two story building was in the shape of an "L", and consisted of an old wing, built prior to 1920, and a new wing, built about 1940. Wehrli began efforts to find a new tenant soon after the purchase, and finally negotiated a five-year lease with Tenneco, Inc. As a condition for entering into the lease, Tenneco required Wehrli to do substantial work to adapt the building to its needs, and submitted a proposed floor plan for the rearrangement of the interior space. It is not clear whether the rearrangement was done in accordance with the submitted floor plan, but the entire work done included the following: air-conditioning the entire building; rearranging the interior space of the old wing by "tearing out" a hallway, the load-bearing wall, and two concrete vaults, and replacing the load-bearing wall with steel support columns: installing, as needed, new wall partitions, floor covering, electrical wiring, and plumbing fixtures; plastering and painting in both wings; moving the rest rooms "from where they were, forward in the building, somewhere to the rear of the building"; and installing new doors.

During 1959 Wehrli's expenditures for the work totaled approximately * * *, of which * * * was reimbursed by Tenneco. In their

joint tax return for that year Wehrli and his wife treated approximately * * * as capital expenditures for air-conditioning, steel, partitions, and exterior doors, and claimed the remaining * * * as deductible business expenses.

7. In Honigman, et al., v. Comm, 72-2 USTC P9613 (1972), US-CT-APP-6, the Court ruled Parking area bay replacements and related engineering surveying expenses were capital expenditures and could not be deducted by the taxpayer as repairs. However, minor patching expenses were deductible.

In fiscal 1961 National expended * * * for repairs of the parking garage floor in the First National Building. Some * * * was spent in the following fiscal year for an engineering survey of the floor to evaluate its condition and recommend corrective measures. National deducted these expenses as current business expenditures. The Commissioner disallowed these expenses, asserting them to have been for capital improvements.

The evidence showed that salt carried into the garage from the street by automobiles during the winter had caused deterioration of the concrete floor and steel reinforcing and supporting structures. The repairs made were of two types: replacement of complete 16 foot square parking bays and minor patching of smaller floor areas. * * * * * *

The Tax Court held that the bay replacements and engineering survey expenses were capitalizable and the patching expenses currently deductible. Under the rule of Cohan v. Commissioner, 39 F. 2d 540 (2d Cir. 1930), $2,500 was allocated to the deductible repairs.

8. In Idaho Power Co v. Commissioner, 74-2 USTC P9521, No. 73-263, 418 US 1, 94 SCt 2757, 6/24/74, Rev'g CA-9, 73-1 USTC P9367, 477 F. 2d 688, which had rev'd 29 TCM 383, Dec. 30,053(M), T. C. Memo. 1970-83 the Supreme Court ruled that costs incurred for equipment used to self-contruct assets must be capitalized and depreciated over the life of the assets constructed and the Court reversed the Tax Court based on several principles such as: 1. Accounting and tax principles 2. Clear reflection of income 3. capitalization of "amounts paid" rules 4. priority order of rules and 5. intent of Congress.

Depreciation sustained on equipment used by a public utility to construct capital improvements for use in its trade or business had to be capitalized as part of the cost of the capital improvements and could not be deducted currently.

Capitalization was required by accepted accounting principles and established tax principles. In Woodward v. Commissioner [70-1 USTC

P9348], 397 U. S. 572, 575 (1970), the Court observed, "It has long been recognized, as a general matter, that costs incurred in the acquisition . . . of a capital asset are to be treated as capital expenditures." This principle has obvious application to the acquisition of a capital asset by purchase, but it has been applied, as well, to the costs incurred in a taxpayer's construction of capital facilities. See, e.g., Southern Natural Gas Co. v. United States, supra; Great Northern R. Co. v. Commissioner [2 USTC P504], 40 F. 2d 372 (CA 8), cert. denied, 282 U. S. 855 (1930); Coors v. Commissioner, 60 T. C. 368, 398 (1973); Norfolk Shipbuilding & Drydock Corp. v. United States [71-1 USTC P9162], 321 F. Supp. 222 (ED Va. 1971); Producers Chemical Co. v. Commissioner [CCH Dec. 29,152], 50 T. C. 940 (1968); Brooks v. Commissioner [CCH Dec. 29,151], 50 T. C. 927, 935-936 (1968), rev'd on other grounds, [70-1 USTC P9326] 424 F. 2d 116 (CA 5 1970).

The construction-related depreciation was not unlike construction wage costs which must be included in the cost of self-constructed assets. In addition, the assimilation into the constructed assets of the investment in the construction equipment (through capitalization of the depreciation) prevented the income distortion that would occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. Also, capitalization of such construction-related depreciation would provide income tax parity among those taxpayers that self-construct assets and those that have it done by independent contractors. It is significant to note that capitalization is required by the regulatory agency and clearly reflects taxable income.

Although Code Sec. 263(a) requires capitalization of "amounts paid out" for facilities, there is no question but that the cost of the construction-related equipment was paid out in the same manner as the cost of supplies, materials, and wages paid for construction.

Finally, the priority-ordering directive of S161--or, for that matter, S261 of the Code, 26 U. S. C. S261 -requires that the capitalization provision of S263(a) take precedence, on the facts here, over S167(a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are "subject to the exceptions provided in part IX." Part VI includes S167 and Part IX includes S263. The clear import of S161 is that, with stated exceptions set forth either in S263 itself or provided for elsewhere (as, for example, in S404 relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

9. In Electric Energy, Inc., v. United States, 87-2 USTC P9587, (1987) US-CL-CT, the Court found the following facts: From 1977 through 1980,

the Corporation carried out a systematic substitution of all the horizontal elements within the economizers of its six boilers. The replacement plan was an economic decision, based upon past maintenance experience, to avoid forced outages.

The Court noted that the sheer amount of the expenditure is not a reliable focal point in this case. Judge Miller in Cleveland Electric Illuminating Co. v. United States [85-1 USTCP9128], 7 Cl. Ct. 220, 224 (1985), described "the fact that a substantial expenditure is likely to give a long lived benefit . . ." as "an important, if not dominant, factor" in determining whether a multi-million dollar outlay should be classified as a repair rather than a capital expenditure. Since one new boiler would cost $17-20 million, however, revitalizing the horizontal elements of each economizer at an approximate cost of $380,000 does not constitute an unusual repair bill.

The Court considered the following:

1. whether "Economizers" are separate units of property. It was found that they are are listed as distinct units of property under the heading "Boilers".

2. The function of "Economizers". Economizers enhances the boiler's ability to convert water into steam.

3. The Corporation's own statistics about the leaks in the horizontal elements - they were caused by fly ash. The erosion was significantly decreased after 1980, with 13 and 12 leaks occurring, respectively, in 1981 and 1982, compared with 25 or more per year in each of the five years preceding commencement of the replacement program in 1977.

4. The effect of the new finless design - which is the state of the art Although the fin model was still utilized, the new tubes would require less maintenance. Although the boilers did not function differently, their performance was improved in that it was not interrupted by frequent forced outages.

The Court found that the prolonged useful life of the economizers alone supports capitalization.

The Court also pointed out the various cases where it was held that a correction of a defect which contributes to prolonging the life of equipment is a replacement, not a repair, and must be capitalized. See Hudlow v. Comm'r [CCH Dec. 30,959(M)], 30 T.C.M. (CCH) 894, 923 (1971) (replacement of major parts put forklift trucks into such condition as to no longer be unduly susceptible to breakdowns); Almac's Inc. v. Comm'r [CCH Dec. 24,620(M)], 20 T.C.M. (CCH) 56, 59 (1961) (retubing of

boiler after 27 years extended useful life by more than a year or two); Ruane v. Comm'r [CCH Dec. 23,176(M)], 17 T.C.M. (CCH) 865, 871 (1958) (substantially rebuilding coke ovens gave them a new life expectancy of three to four years).

Improvement of preexisting equipment is suggestive of capitalization. The Court of Claims has applied capitalization when a repair results in a "substantial functional improvement" through application of a superior part. Missouri Pacific RR. v. United States [74-1 USTC P9389], 204 Ct. Cl. 837, 854, 497 F.2d 1386, 1396 (1974); see also Southern Pac. Transp. Co. v. Comm'r [CCH Dec. 37,600], 75 T.C. 497, 718 (1980).

Overall the Court found that the evidence was probative of prolonging the life of the economizers than constituting a betterment. Replacement of the horizontal elements allowed the Company to begin a new 20-plus-year repair cycle which reduced the probability of pluggage and erosion. The greatly reduced number of leaks since 1980, compared with the accelerating increase in leaks between 1953-1977, proves the point.

10. INDOPCO, Inc., v. Comm 92-1 USTC P50,113, Supreme Court of the United States, 90-1278, 2/26/92, 112 SCt 1039; affg. CA-3, 90-2 USTC P50,571, 918 F.2d 426.

On its 1978 federal income tax return, the corporation claimed a deduction for certain investment banking fees and expenses that it incurred during a friendly acquisition in which it was transformed from a publicly held, freestanding corporation into a wholly owned subsidiary. The Commissioner disallowed the claim. The Tax Court ruled that because long-term benefits accrued to petitioner from the acquisition, the expenditures were capital in nature and not deductible under 5162(a) of the Internal Revenue Code as "ordinary and necessary" business expenses. The Court of Appeals affirmed, rejecting petitioner's argument that, because the expenses did not "create or enhance . . . a separate and distinct additional asset," see Commissioner v. Lincoln Savings & Loan Assn. [71-1 USTC P9476],

The Supreme Court expatiated the relationship between deductions and capital expenditures, and noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." Interstate Transit Lines v. Commissioner [43-1 USTC P9486], 319 U.S. 590, 593 (1943); Deputy v. Du Pont [40-1 USTC P9161], 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering [4 USTC P1292], 292 U.S. 435, 440 (1934).

The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions

are specifically enumerated and thus are subject to disallowance in favor of capitalization. See SS161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," Lincoln Savings [71-1 USTC P9476], 403 U.S., at 358, S263 serves as a general means of distinguishing capital expenditures from current expenses. See Commissioner v. Idaho Power Co. [74-2 USTC P9521], 418 U.S., at 16. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." New Colonial Ice Co. v. Helvering [4 USTC P1292], 292 U.S., at 440; Deputy v. Du Pont [40-1 USTC P9161], 308 U.S., at 493. \4/

The Court considered whether a taxpayer's realization of benefits beyond the year in which the expenditure is incurred and concluded that it is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. See United States v. Mississippi Chemical Corp. [72-1 USTC P9276], 405 U.S. 298, 310 (1972) (expense that "is of value in more than one taxable year" is a nondeductible capital expenditure); Central Texas Savings & Loan Assn. v. United States [84-1 USTC P9471], 731 F.2d 1181, 1183 (CA5 1984) ("While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item.").

The Court applied the foregoing principles to the specific expenditures at issue in this case, and concluded that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under S162(a).

* * * *

Similarly, the expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as "ordinary and necessary" business expenses under S162(a). The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

11. In Phillips and Easton Supply Company v. Commissioner, 20 TC, 20 TC 455, (1953), it was held that the expense of installing the new floor was a capital expenditure.

The Company was in business since 1916. It occupied continuously a two-story building which was constructed in 1900 and was of brick and had a gravel roof and a cement floor. It was located four blocks from the center of the town of Wichita, and, also, it is about 100 yards from the bank of the Arkansas River. The building was not located in a

flood area. It was rented during the years 1916 to 1920; it purchased the land and building in 1920 for $22,621.02, of which amount $14,621.02 was allocated to the building. All of the cost of the building was recovered through depreciation by December 31, 1945.

The original cement or concrete floor of the building remained in place until 1946, when it was taken out and replaced, except for an area of 225 square feet which was taken out and replaced in about 1943. When a new floor was installed in 1946, the area of 225 square feet was not taken up but remained. The old concrete floor was not reinforced; it was 23 inches thick. The area of 225 square feet of new floor is 5 inches thick. The new concrete floor, installed in 1946, is 5 inches thick and is reinforced. The building code of Wichita requires that cement floors shall be 5 inches in thickness.

When the new concrete floor was installed in 1946, all the lavatories, offices, partitions, bins, and stocks of goods--were moved. The Company carried on its business throughout the period when the floor was installed. The new floor was laid in sections of 16 square feet, and all the work of moving equipment, taking out sections of the old floor, and putting in 2 sections was done in piecemeal fashion, so that the work was done progressively. The only new installation was the floor. Partitions, bins, and lavatories were merely moved and relocated as the new floor was laid, except that new tile was required to cover the floor area of the offices, and the plastered partition was, in part, recovered with plaster board. Some amount of painting was done when the work was finished.

The evidence on the whole shows that the old floor wore out; that it had been patched and repaired to such an extent that further patching was not practical; and that the business of petitioner had expanded to include the handling of heavy goods and equipment which the old floor could not support without the effects of the heavier wear entailed. The floor which was replaced was the original floor of the building, and it was 46 years old. Furthermore the cost or basis of petitioner's building had been fully recovered through depreciation allowance before January 1, 1946, so that the old floor had been completely depreciated.

The evidence shows, clearly, that the new floor represented a replacement and an improvement; and that it was not merely a repair which kept the building in ordinarily efficient operating condition. See, Illinois Merchants Trust Co., Executor, 4 B. T. A. 103 [Dec. 1452]; and Regulations 111, Section 29.23(a)-4. The installation of the new floor was an extensive job, and for practical purposes it amounted to putting in an entire floor, because the 225 square feet of new floor in the rear of the building represented only a small and minor part of the entire floor area. The removal of the old floor and the installation of the new floor was a substantial, structural work. Cf. Buckland v.

United States, 66 Fed. Supp. 681, 683 [46-1 USTC P9273]. The new floor made the building more valuable for the use of the petitioner in its business, particularly because it accommodated the storing, handling, and moving of heavy equipment and inventories. Black Hardware Co. v. Commissioner, 39 Fed. (2d) 460 [2 USTC P498], certiorari denied, 282 U. S. 841; Amsterdam Theatres Corporation, 24 B. T. A. 1161 [Dec. 7338].

12. In Richard E. Donovan v. Commissioner Docket No. 5336-88., TC Memo. 1990-373, 60 TCM 184, (1990), the Court ruled that the expenditures of $172,000 made for the purchase of wind turbines should be capitalized. T/P argued that the purchase of the wind turbines was necessary (1) to enable the partnerships to earn income and (2) to quiet unhappy investors. Generally, the cost of acquisition of property with a useful life substantially beyond the taxable year is a cost that is capital in nature, per Sec. 1.263(a)-2(a), or the Income Tax Regs. Further per Sec. 168 of the IRC the type of property of the T/P has a useful life substantially beyond the year of purchase.

13. Godfrey et al v. Comm 64-2 USTC P9668, (CA-6), U. S. Court of Appeals, 6th Circuit, No. 15386, 335 F2d 82, 7/29/64, Affirming Tax Court, 22 TCM 1, CCH Dec. 25,899(M), T. C. Memo. 1963-1, the Court ruled that- " use survey", which was the first step in the taxpayer's contemplated development of commercial property, was a capital expenditure rather than an ordinary business expense. Likewise, the legal fees incurred in an unsuccessful effort to have the zoning classification of the land changed to one that would permit it to be used in the manner indicated by the survey were capital expenditures.

In this regard the Tax court said, "use-survey" costs represent:

" * * * * first step in the contemplated development of the property; and its benefits were obviously expected to extend beyond the year in which the survey was made." The test of an ordinary business expense is whether it is of a recurring nature and its benefit is generally exhausted within a year. An expenditure is of a capital nature "where it results in the taxpayer's acquisition or retention of a capital asset, or in the improvement or development of a capital asset in such a way that the benefit of the expenditure is enjoyed over a comparatively lengthy period of business operation." Louisiana Land & Exploration Co. v. Commissioner [CCH Dec. 15,308], 7 T. C. 507 aff'd, [47-1 USTC P9266] 161 F. 2d 842, C. A. 5; See Commissioner v. Boylston Market Ass'n [42-2 USTC P9820], 131 F. 2d 966, C. A. 1; Clark Thread Co. v. Commissioner [38-2 USTC P9440], 100 F. 2d 257, C. A. 3; Parkersburg Iron & Steel Co. v Burnet [1931 CCH P9201], 48 F. 2d 163, C. A. 4. Shainberg v. Commissioner [CCH Dec. 23,838], 33 T. C. 241, relied upon by the taxpayer, involved a financing survey which was regarded as a recurring cost and is factually distinguishable from the

the Court looked at whether any properly performed repair added value to the property as compared to the situation immediately before the repair was done, and determined that "the proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."; see also Plainfield-Union Water Co. [Dec. 25,740], 39 T. C. 333, 337-338 (1962).

17. Almac's Inc. v. Commissioner 20 TCM 56, TC Memo. (1961) the Court ruled that the expenditures of $1,935.50 paid in 1956 for retubing the boiler were capital expenditure as the retubing undoubtedly added to the useful life of the boiler, and that, by more than a year or so, although the T/P did not show as to the relative costs of replacing the entire boiler or how extensive a job it was to retube. The boiler which was installed in 1929, was located in a building at its Park Street store in Woonsocket, Rhode Island, which was formerly a transit company carbarn and was purchased and remodeled by petitioner in 1955 for use as a supermarket. During the first heating season after the Company acquired, the boiler tubes carbonized rapidly and six or seven tubes leaked.

18. In Phillips & Easton Supply Co., 20 T. C. 455 (1953), the expense of installing a new floor in the taxpayer's building was held to be a capital expenditure. The old floor was 46 years old, and had so deteriorated that further repairs were not practical; such old floor had been previously patched in various places. The new floor was a replacement of the old one.

19. In Alexander Sprunt & Son, Inc. 24 B. T. A. 599 (1931), revd. on other grounds [1933 CCH P9263] 64 F. 2d 424 (C. A. 4, 1933), for the proposition that the cost of replacing an inadequate structure which no longer serves its intended purpose with a better and more substantial structure of the same type must be treated as a capital expenditure. The taxpayer replaced a wooden wall with a concrete wall.

20. In Teitlebaum v. Commissioner [61-2 USTC P9632], 294 F. 2d 541 (7th Cir. 1961), cert. denied, 386 U. S. 987 (1962), the Tax Court said that the money spent by the taxpayer to convert the electrical system at a building from D. C. to A. C. to meet the city's regulations was a capital expenditure. The Seventh Circuit agreed, reasoning that even if such a modification did not improve the property by increasing its attractive appearance or efficiency, or prolonging its life, it did render the property more valuable by bringing the property into compliance with applicable regulations.

21. The Court stated in Hertz Corp. v. United States [60-2 USTC P9555], 364 U. S. 122, 126 (1960): "[T]he purpose of depreciation accounting is to

allocate the expense of using an asset to the various periods which are benefited by that asset." See also United States v. Ludey [1 USTC P234], 274 U. S. 295, 300-301 (1927); Massey Motors, Inc. v. United States [60-2 USTC P9554], 364 U. S. 92, 96 (1960); Fribourg Navigation Co. v. Commissioner [66-1 USTC P9280], 383 U. S. 272, 276-277 (1966).

22. In Claussner Hosiery Company v. Commissioner, Docket No. 18624, 9 TCM 891, the T/P decided to have the machines reconditioned and certain of the moving parts rebuilt. The parts of the machines involved in this reconditioning were shipped to Robert Reiner, Inc., a knitting machine manufacturing company.

The reconditioning of these machines added materially to their value, appreciably prolonged their lives, and made good, to the extent of its added life, the exhaustion of the original useful life of the machine for which depreciation allowance had been made. The normal useful life of the machines in question had been exhausted and the expenditures for reconditioning are shown to have materially increased their value and life.... Under these conditions we think the expenditure was capital in character and recoverable over the additional span of useful life given to the machines by the reconditioning. Marsh Fork Coal Co. v. Lucas, 42 Fed. (2d) 83 [2 USTC P550]. 971-218, Filed August 30, 1971

APPLICATION OF LAW:

As described above the Courts applied various tests to determine whether an expenditure is capital or repair. In general, the Courts ruled that expenditures incurred as part of a general plan of rehabilitation, modernization, and improvement of the property, are capital in nature, ILLINOIS MERCHANTS TRUST CO v. Commissioner, 4 B.T.A. 103, 106, acq., V-2, C.B. 2 (1926); Phillips and Easton Supply Company v. Commissioner, 20 TC, 20 TC 455, (1953); INDOPCO, Inc., v. Comm 92-1 USTC P50,113, Supreme Court of the United States, 90-1278, 2/26/92, 112 SCt 1039; affg. CA-3, 90-2 USTC P50,571, 918 F.2d 426; Electric Energy, Inc., v. United States, 87-2 USTC P9587, US-CL-CT (1987); Claussner Hosiery Company v. Commissioner, Docket No. 18624, 9 TCM 891; Accurate Tool Co., Inc. v. Commissioner, Docket Nos. 8802, 10029, 10097, 10 TCM 354, (1951)

The Courts also ruled that any engineering costs that are related to planned modernization, replacement etc., are capital expenditures see, Home News Publishing Co. v. Commissioner, 18 B.T.A. 1008 (1930) United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968) Honigman 55 T. C. 1067, 1081 (1971)

In Electric Energy, Inc., v. United States, 87-2 USTC P9587, US-CL-CT (1987) and also in INDOPCO, Inc., v. Comm 92-1 USTC P50,113,

Supreme Court of the United States, 90-1278, 2/26/92, 112 SCt 1039; affg. CA-3, 90-2 USTC P50,571, 918 F.2d 426, the Supreme Court discussed at great length, the purpose, function and performance of assets to determine whether certain expenditures are capital.

In addition to the above case Law, the Engineer addressed the T/P's unique arguments about the applicability of various Code and Regulation sections dealing with "Unit of Property", "Placed-in-service" and Investment tax Credit", in a separate 886-A that was submitted to the T/P on 2-22-95.

UNIT OF PROPERTY ARGUMENTS:

1. There are no guidelines as to a "Unit of property" for determining whether an expenditure adds value to, prolongs the life of, increases the productivity of, or repairs property. In order to get an understanding of this we have to refer to the most recent case, UNITED STATES v. WISCONSIN POWER & LIGHT CO. UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT, 38 F.3d 329; U.S. App. 94-2 USTC P50,547, (1994), where the Court reviewed the Treas. Reg. Sec. 1.167(a)-11(d)(2)(vi) for definition of "Unit of Property" and made the following comments:

"... In order to decide if customer service drops are excluded additions, we must determine the applicable "unit of property."

* * *

The regulation itself is not entirely clear on how to define units of property for utility property and both of the interpretations advanced by the parties to determine a unit of property are plausible. Subsection (g) does apply to utility property and the text following the definitions of excluded property does not clearly specify whether the definition of unit of property for expenditures described in subsection (g) applies only to the expenditures described in subsection (g) or to all utility property. In this section of the regulation, the sentence describing the unit of property for subsection (g) directly follows the sentence describing the treatment of component parts as units of property for machinery and equipment under subsection (d)(1). This juxtaposition suggests that machinery and equipment should be treated differently from utility property. However, the general definition of "unit of property" refers to "each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function.." This definition suggests that any operating unit, including a unit of utility property, is considered machinery or equipment and, thus, the special treatment of additions to machinery and equipment under subsection (d)(1) applies to utility property."

The Court further commented:

"..The IRS's position articulated in Revenue Ruling 78-67 is entitled to considerable weight. "Although the Service's interpretive rulings do not have the force and effect of regulations, we give an agency's interpretations and practices considerable weight where they involve the contemporaneous construction of a statute and where they have been in long use." Davis v. United States, 495 U.S. 472, 484, 109 L. Ed. 2d 457, 110 S. Ct. 2014 (1990) (citations omitted). Furthermore, "when the construction of an administrative regulation rather than a statute is at issue, deference is even more clearly in order." Udall v. Tallman, 380 U.S. 1, 16, 13 L. Ed. 2d 616, 85 S. Ct. 792 (1965). "The ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation." Bowles v. Seminole Rock Co., 325 U.S. 410, 413-14, 89 L. Ed. 1700, 65 S. Ct. 1215 (1945).

The Service has long followed the position articulated in Revenue Ruling 78-67. Revenue Ruling 78-67 was issued in 1978. Prior to the publication of this ruling, the Service issued a General Counsel Memorandum dated October 20, 1977, ("GCM 37297") which discussed the proposed revenue ruling which later was issued as Revenue Ruling 78-67. Although GCMs have no precedential value, they are "helpful in interprating the Tax Code when faced with an almost total absence of case law.'" Morganbesser v. United States, 984 F.2d 550, 563 (2d Cir. 1993), quoting Herrmann v. E.W. Wylie Corp., 766 F. Supp. 800, 802-03 (D.N.D. 1991)."

The Court further argued about accepting or rejecting the T/P's "Units of property" in the following manner:

"..Immediately after Treasury Regulation @ 1.167(a)-11(d)(2)(vi) provides the general definition for units of property, the regulation states, "the taxpayer's accounting classification of units of property will generally be accepted for purposes of this subdivision provided the classifications are reasonably consistent with the preceding sentence and are consistently applied." (emphasis supplied). The fact that WPL had established units of property and consistently had applied those classifications during the years in question is not determinative for two reasons. First, WPL's units of property were not consistent with the regulation's treatment of additional units of property and thus the Service is not obligated to accept these units of property even though consistently applied. Second, even though the Service did accept WPL's classification for the years in question, this was in light of WPL's prior treatment of the expenditures in question. When WPL attempted to treat these expenditures differently, the Service was no longer obliged to accept

these units of property. As the district court stated, "Equity does not demand that where the United States accepts a prior characterization it continues to be bound by a subsequent amendment claiming substantially greater deductions than those claimed on the original return. To hold otherwise would permit a taxpayer to parlay a minor deduction into a subsequent major deduction by estopping the government from objecting to its methodology."..."

The burden of showing the right to a claimed deduction is on the taxpayer. See, e.g., Hefti v. Internal Revenue Service, 8 F.3d 1169, 1173 (7th Cir. 1993). Whether the taxpayer has produced sufficient evidence to support a deduction is a question of fact which we review for clear error. See Betson v. Commissioner of Internal Revenue, 802 F.2d 365, 367 (9th Cir. 1986)."

Based on the above discussion, the Engineer concludes that the definition of "Unit of Property" should be same as the Court concluded, which is:

"Unit of Property" is "each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function..."

The Court also applied this definition to a unit of utility property.

2. FERC requires the Utility Companies to follow certain guidelines and prescribed certain Account categories for the Property, Plant & Equipment. For Nuclear Generating Plants, it requires to include under Plant Account 322, all the Nuclear Reactor Plant Equipment. All other Plant Accounts are same as for Steam Generation. Each Plant Account has Subsystems and each Subsystem is composed of several single identifiable units of property, such as valves, recordars, pumps, heaters, control/instrumentation systems, piping, turbine generators, etc.

The T/P provided the listing of the various Plant Account categories during the second week of February 1995. The Engineer reviewed the computer listing of the items. Under each Plant Account such as 322, 323, 324 etc., a "system code" was found with a "System Title" and each "System Title" has a brief description about the "System". Further, each "system" is broken down to "INDIVIDUAL UNITS" called "Retirement Units", which are essentially a "Unit of property", and are assigned "Retirement Unit Codes" to keep track of items of each piece of property.

Two Plant Account categories are listed below:

1. PLANT ACCOUNT 322 : REACTOR PLANT EQUIPMENT

SYSTEM CODE	SYSTEM TITLE
151	REACTOR VESSEL AND INTERNALS

SYSTEM DESCRIPTION: This system includes installation associated with containment of fuel and moderator within the Reactor vessel. The system boundaries are at the Reactor coolant piping welds to the vessel and at the connections to the vessel head and instrumentation penetrations. It does not include rods, incore instrumentation nor nuclear fuel.

RETIREMENT UNIT CODE	RETIREMENT UNIT DESCRIPTION	PROPERTY UNIT
0345	FOUNDATION	EACH
0351	HEAD, REACTOR	EACH
0357	INSTRUMENTATION PENETRATION SEALS (CONOSEALS)	ALL
0361	LEAKE DETECTION SYSTEM	EACH

2. PLANT ACCOUNT 323 : TURBOGENERATOR UNITS

SYSTEM CODE	SYSTEM TITLE
271	STEAM TURBINE

SYSTEM DESCRIPTION: This system includes the turbine that drives the main generator to produce electric power. The system boundaries are at the welds to the main steam and reheat piping systems, the connection at the turbine casing to each extraction pipe at the turbine, the connection to the condenser expansion joint, the generator half of the turbine-generator coupling (see System 465), the closest connections to the lube oil system at the turbine. It does not include lube oil piping external to the turbine, nor the gland seal system, nor the turbine control system. The system includes sole plates, shims and other parts supporting the turbine on the pedestal.

RETIREMENT UNIT	RETIREMENT UNIT DESCRIPTION	PROPERTY

CODE		UNIT
1536	CASING OR SHELL	EACH SEC
*	* *	
1542	HIGH PRESSURE TURBINE WHEEL	EACH
*	* *	
1549	COUPLING COMPLETE WITH FASTENERS	EACH
*	* *	
1552	INTERMEDIATE PRESSURE TURBINE WHEEL * * *	EACH
1557	LOW PRESSURE TURBINE WHEEL	EACH
*	* *	
1563	INSULATION-PIPING, RUN 4 IN OR LARGER	FEET

From the review of the T/P's records, it is concluded that the T/P considers each single item of machinery & equipment as a "Unit of Property", and follows the guidelines of FERC as to capitalization of the various expenditures, that are outlined in the Summary sheet, EXHIBIT A. T/P claims that these "Units of Property" are for book purposes only, and not for tax purposes. However, T/P does not make any distinction for depreciation for tax purposes, the only distinction he makes is the life for tax purposes.

Based on the above discussion and the Court case, UNITED STATES v. WISCONSIN POWER & LIGHT CO. UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT, 38 F.3d 320; U.S. App. 94-2 USTC P50,547, (1994), the Engineer concludes that "Unit of Property" has the same meaning for tax purposes, as for book purposes. Therefore, the T/P's argument that "Unit of Property" is the entire Nuclear Plant is rejected.

PLACED-IN-SERVICE RULES:

The next question to address is whether the "Placed-in-Service" and Investment Tax Credit Sections and case law apply to the Repairs issue. Let us discus. the relevancy of the various Revenue Rulings and cases referred to by the T/P's Representative.

1. Although the phrase "placed in service" is not defined in the statute, section 1.168-2(l)(2), Proposed Income Tax Regs., 49 Fed. Reg. 5956 (Feb. 16, 1984), states:

   (2) Placed in service. The term "placed in service" means the time that property is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function, whether for use in a trade or business, for the production of income, in a tax-exempt activity, or in a personal activity. * * *

2. Rev. Rul. 76-428, 1976-2 CB 47, discusses about a nuclear electric generating unit ("unit") and what date it was first placed in service for depreciation and investment credit purposes. The T/P owns a unit, construction of which commenced in September 1972. The unit was constructed for the taxpayer pursuant to a contract. The major components that are necessary to the operation of the unit include: a nuclear steam supply system; a reactor auxiliary system; a control and safety instrumentation system; a radioactive waste disposal system; a fuel handling and storage system; a turbine system; and a containment system (emphasis added).

It was ruled that the nuclear generating unit was "first placed in service" on December 23, 1975, for depreciation and investment credit purposes, based on the following facts:

a. It was in a condition or state of readiness and availability for a specifically assigned function.
b. All necessary permits and licenses had been approved.
c. All the critical tests for the various components had been completed.
d. The nuclear generating unit had been placed in the control of the owners who possessed all the legal attributes of ownership, by the contractor.
e. The generating unit had been synchronized into the taxpayer's power grid for its function in the business of generating nuclear electric energy for the production of income, even though the generating unit would undergo further testing to eliminate any defects.

The assertion by the T/P that this Revenue Ruling should be the basis for determining that all the expenditures made to the various "Units of Property" qualify as Repairs, because the Revenue Ruling considers the nuclear generating unit as a "Unit". The above Revenue Ruling considered whether the various components, are performing the functions what they are designed for and all the critical tests have been completed on the various components. The components are the same items that are described in the various Plant Accounts under FERC System.

The T/P's assertion is misplaced and misguided. The District Court made the following comments in the case, UNITED STATES v. WISCONSIN POWER & LIGHT CO. UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT, 38 F.3d 329; U.S. App. 94-2 USTC P50,547, (1994), when the T/P wanted to change character of items in its case, ".. Equity does not demand that where the United States accepts a prior characterization it continues to be bound by a subsequent amendment claiming substantially greater deductions than those claimed on the

original return. To hold otherwise would permit a taxpayer to parlay a minor deduction into a subsequent major deduction by estopping the government from objecting to its methodology...."

Originally, in the instant case the T/P claimed the expenditures as capital expenditures. Subsequently, the T/P submitted a claim to change the character of the items and has come up with the theory that the entire plant should be considered as one "Unit" and therefore, all the expenditures should be treated as current deductions.

Based on the facts in the present case and above discussion, the Engineer concludes that the Rev. Rul. 76-423 has no bearing on the present case about the determination of whether the expenditures should be capitalized or expensed and therefore, the T/P's claim is being denied, to let the expenditures be considered as expenses, currently deductible.

3. In Rev. Rul. 76-238, 1976-1 CB 55, the IRS ruled in the following manner in regards to the two issues about "Placed-in-Service" dates:

   a. A building, constructed to house manufacturing facilities, was placed in service for depreciation purposes on the date its construction was completed and available for installation of machinery and equipment.

   b. machinery, installed therein over a period of months, was placed in service when the entire production line was available for the production of an acceptable product.

   This Revenue Ruling is not applicable to the present case, where an expenditure is capital or expense.

4. Rev. Rul. 73-518, 1973-2 CB 54, the taxpayer, an electrical utility company, constructed a major transmission line in 1970 that was dead-ended into steel towers at each end of the line. The necessary substations at each end of the line were completed in 1971 and the line was energized.

   Again, this is not an applicable Revenue Ruling in the present case.

5. In Hawaiian Independent Refinery, Inc. v. United States [83-1 USTC P9141], 697 F.2d 1063 (Fed. Cir.), cert. denied 464 U.S. 816 (1983), the court addressed the placed-in-service date of an oil refinery complex. The complex consisted of the refinery facility, an offshore tanker-mooring facility located two miles from the refinery and connected to the refinery by a pipeline system, and two pipelines used to transport finished products from the refinery to various storage

of high or peak electrical power demand.

The turbines and other equipment associated with the physical facilities at the Ludington Plant consist primarily of six tunnels or penstocks, the pumphouse, and six reversible pump-turbine generators which are designated Unit 1 through Unit 6. The penstocks connect the upper reservoir with the pumphouse in which the pump-turbine generators are located. The plant was designed so that upon the successful completion of preoperational testing of Unit 1 the Ludington plant would become operational and would begin selling electrical power to the Michigan Power Pool even though the other five generating units were still under construction.

On the evening of December 7, 1972, in conjunction with one of the final preoperational tests in the pumping mode, electrical power to Unit 1 was temporarily disrupted. When this happened, Unit 1 did not automatically shutdown as designed, but, due to a mechanical failure, reversed into the generating mode, damaging certain parts of the turbine generator. As a result, further preoperational testing was suspended, and Unit 1 was shut down for repairs. The repairs to Unit 1 were completed on January 9, 1973, and preoperational testing was resumed. On January 17, 1973, testing of Unit 1 was completed, and Unit 1 formally was accepted by petitioner from the general contractor. On January 18, 1973, electrical power generated from Unit 1 was available for transmission into the Michigan Power Pool.

Although Unit 1 pumped water into the reservoir and generated electrical power during preoperational testing in 1972, Unit 1 was not available in 1972 to provide electrical power on a regular basis in 1972. The amount of electrical power generated in 1972 is insufficient to establish that the Ludington Plant was available for full operation on a regular basis in 1972. The generation of electrical power and the pumping of water into the upper reservoir were both necessary parts of preoperational testing. Accordingly, the production of some electrical power (even the sale thereof) and the filling of the upper reservoir to within five feet of the high-pond level do not establish that the Ludington Plant was available for use in 1972. Not until January 17, 1973, after Unit 1 successfully had completed all phases of preoperational testing, thereby demonstrating that it was available for service on a regular basis, was the unit in a state of readiness and availability for its specifically assigned function within the meaning of sections 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i), Income Tax Regs.

In the above case, the Court was asked to decide <u>for purposes of depreciation and investment credit</u>, whether the <u>Plant was placed</u>

in service in 1972. This case is irrelevant to the instant case where, the question is whether the expenditures to the various items of property should be capitalized.

OTHER CASES - REPAIRS:

A. The T/P quoted the following cases where the Courts applied "..the repair tests to integrated unit rather than to the component parts". The Engineer reviewed the cases and could not find any reference to the "Unit of property".

1. In Midland Empire Packing Co. v. Commissioner, 14 TC 635, the issue was "..whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under section 23 (a) of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section 23 (f) of the Internal Revenue Code..."

The Court found "..that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not. and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. ....the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oil-proof the basement, or else shut down its plant.. during the taxable year under took steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oil proofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred..." (emphasis added).

The Court found that ".. the expenditure served only to permit petitioner to continue the use of the plant, and particularly the

basement for its normal operations" and held that the expenses are ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code.

The above case is not relevant in the instant case, because the T/P is replacing items of machinery and equipment that have reached their useful lives and the new items are improved and are more efficient, and therefore should be capitalized, see the various cases cited in the original FORM 5701.

2. In HAWAIIAN SUGAR CO., v. COMMISSIONER OF INTERNAL REVENUE, (Oct. 1, 1928) 13 B.T.A. 683; (Oct. 1, 1928), the Company is engaged in the operation of a sugar cane plantation and sugar mill in Honolulu. During the course of manufacturing the 1922 crop of cane into raw sugar one of the rollers in the crushing mill broke and was replaced at a cost of $2,543.43. Crusher rollers are used in crushing cane to extract the juice from which the sugar is manufactured. These rollers are about 55 inches in diameter and about 78 inches long and consist of a shell and shaft. The shell is made of cast iron, weighs from 12 to 13 tons, and the rollers operate under a pressure of about 450 tons and are subject to considerable wear.

The expense was allowed to replace the broken crusher roller based on the following reasoning: ".. that such rollers are only a part of the mill, that they are operated under heavy pressure, and are subject to frequent replacement, that such replacement is necessary to the operation of the mill but does not extend the life of the mill as a whole, that such rollers have a maximum useful life of three years and a much shorter average life. Breakage is so frequent an occurrence that spare rollers are always carried at the mills in order that broken rollers may be replaced without loss of operating time at the mill.." (emphasis added).

In this case, the Court considered the frequency of replacement of the rollers and where the T/P demonstrated that the maximum useful life of the rollers was only 3 years. However, in the instant case, the T/P has not demonstrated the maximum useful lives of any of the items of equipment, and therefore, the above case is not applicable.

3. In Philip Shore and Ann E. Shore, et al. v. Commissioner, 18 TCM 721, TC Memo. 1959-166, (1959), the Court made the comment that ".. there is no simple distinction between a "repair" and a "capital improvement." As stated in Libby & Blouin, Ltd., 4 B. T. A. 910, at p. 914 [Dec. 1637], "An item, which might be classified as a capital expenditure under certain circumstances, may, under different facts and circumstances, be considered expense." The question is one of fact as to the "purpose and effect" of the expenditure. Farmers Creamery Co. of Fredericksburg, Va., 14 T. C. 879 [Dec. 17,646].

"While it is perhaps true, as respondent argues, that the replacement of an entire engine would ordinarily be considered a capital item, we feel the special facts and circumstances of this case bring the engine replacement expense within the classification of repairs. Clearly the engine replacement expenditures did not have the effect of improving the vessel or adding to its value or useful life. They were expenditures for the purpose of keeping the vessel in an ordinarily efficient operating condition for the remaining five to seven years of the ship's life. As the marine surveyor testified, the vessel without propulsion was merely so much scrap metal. The evidence shows that, because of the condition of the bottom of the vessel it had an extremely limited life. The expenditures for installing secondhand engines were solely to give the vessel the necessary propulsion to the end of that useful life. The expenditures were for items that merely served to restore the vessel to its condition before the crankshafts on the obsolete motors broke, without prolonging the life of the vessel or increasing its value. That the entire engines were replaced by used engines, instead of replacing only the broken crankshafts, is satisfactorily explained. The installation of the used engines, at a cost no greater than crankshaft replacements, was solely for the purpose of doing what replaced crankshafts would do, namely, propel the ship as long as its weak and damaged bottom permitted it to remain afloat." (emphasis added).

In the above case, second hand engines were installed in the ship. However, in the instant case the T/P installed all new items of property which are improved and of better design and it is done as a part of its 20-year overhaul and therefore, the above case is not applicable.

B. The Engineer did not find any merits in the arguments of the T/P or in the case law the T/P made references to, that would require the I.R.S. to consider the entire Nuclear Plant as one Unit, and allow all the expenditures connected with replacement of machinery and equipment that prolong the life of the property, increase its value, or make it adaptable to a different use, as currently deductible, see Illinois Merchants Trust Co. v. Commissioner, 4 BTA 103, 106 (1926), acq., V-2 C.B. 2 (1926), Electric Energy Inc., v. United States, 13 Cl. Ct. 644 (1987), Sections 1.162-4, 1.263(a)-1(b) of the Regulations.

DISCUSSIONS WITH N.R.C.:

The Engineer contacted Dr. Scott Newberry, Director of License Renewal and Environmental Review, Project Directorate, N.R.C., Rockville, Md and enquired about the process of License extension for Nuclear Generating Plants. Dr. Newberry made the following observations:

1. Part 54 of the N.R.C. Regulations which were issued in 1991 are being revised based on the various public hearings that were completed last year.
2. The new Regulations provide options to the Owners of the Plants to request extensions beyond the 40 year current Operating Licenses. Then NRC will conduct the Aging Management Reviews before approvals.
3. Baltimore Gas & Electric Co., operates 2 Nuclear Units, at Calvert Cliffs, Md., that have been in production since 1975, indicated to the NRC that they would be requesting for Operating License extension, beyond the current 40 years and would be submitting their application next year.
4. B & W Owners Group with several Plants informed the NRC that the Group will be filing applications within the next two months with the NRC for extension of the 40 year licenses. Incidentally, the T/P claimed R & D credits for the expenditures of $364,450 for 3 years from 1989 to 1991, which the Engineer disallowed.

At Port St. Lucie Plant under the following Work Orders 1673, 1716, 2404, 2449, 2466, 2500, 2925, 2353 and 2926 the assets have been replaced with new units which are of better and advanced design and also the old assets either reached the end of the design life or rusted.

Under the Work Orders 2786 & 2787 at Port St. Lucie the assets are being replaced in an orderly and planned fashion and the assets are to be placed in service 1996-1998.

At Turkey Point under Work Orders 1261, 1265, 2250, 2324, 2334, 2381, 2784, 2798, 2885, 2938, 2940, 3580, the assets are being replaced with upgraded and modern design. The old assets are either obsolete or rusted and reached the end of design/useful life.

ENGINEER'S CONCLUSIONS:

Based on the Sections of the Code, Treasury Regulations and discussion of case law, the Engineer concluded that the 25 Work Orders, discussed above should remain as "capital" assets as originally classified by the T/P.

EXAMINER'S CONCLUSION

An agreement was reached with the taxpayer. The taxpayer is allowed an a deduction for repairs in the amount of $10,899,887. The expenses are allowed, not under the plant as a single asset theory, because they represent expenses for items the taxpayer claims as repairs to units of property (i.e. boilers etc.) and replacement of items not considered a unit

of property. The dollar amounts are as follows:

Amounts allowed per Engineer"s original report....	$ 6,563,247
Amounts allowed per Taxpayer's Agreement.....	4,336,640
TOTAL	$ 10,899,887

Recapture of the depreciation taken on the amounts allowed as repairs, and the alterantive minimum tax will be addressed as separate issues.

Form 5701 NOTICE OF PROPOSED ADJUSTMENT

Name and Address of Taxpayer S.S.N. or E.I.N.: 59-2449419 Issue No: 0097
FPL GROUP, INC. & SUBSIDIARIES FPL GROUP, INC. - TAX DEPT.
P.O. BOX 088801
Date Issued: 4/6/95
NORTH PALM BEACH FL 33408

Entity No: 000002 Entity: FLORIDA POWER & LIGHT COMPANY

Proposed By: NANCY HOLDER Title: REVENUE AGENT

Submitted To: DOE CRAGHAN Title: TAX DEPARTMENT Response Due: 4/12/95

Authorized Representative's Action:
__Agree __Agree In Part __Disagree __Have Additional Information; Will Submit By: _____

James C Higgin V.P., Tax 5/9/95
Authorized Signature Title Date

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Year	Issue Raised	Category	Amount
8812	CLAIM - ACCRUED VACATION PAY	INC/DEC TAXABLE INCOME	3,111,283.00
8912	CLAIM - ACCRUED VACATION PAY	INC/DEC TAXABLE INCOME	(630,268.00)
9012	CLAIM - ACCRUED-VACATION PAY	INC/DEC TAXABLE INCOME	(4,411,878.00)
9112	CLAIM - ACCRUED VACATION PAY	INC/DEC TAXABLE INCOME	(4,411,878.00)

54-4 pg 2

For Explanation Of Items See Attached Pages

Case Manager: JUDITH HERMAN 4-6-95
Date

Confidential (1)

Page 1
Form CG5701 up 54-4 2

Form 886-A (Rev. 4-86)	EXPLANATION OF ITEMS	Schedule No. or Exhibit
Name of Taxpayer	FPL Group, Inc. & Subsidiaries Subsidiary: Florida Power & Light Company	YEAR/PERIOD ENDED 1988-1992

ACCRUED VACATION PAY

	1988	1989	1990	1991
Net Adjustments to Income	$3,111,283	($630,268)	($4,411,878)	($4,411,878)

See page 4 for calculations

ISSUE

To consider an informal claim submitted to correct the computation of vacation pay for Florida Power & Light Company for the tax year 1988.

FACTS

The taxpayer filed an informal claim attempting to correct two errors in the calculation of the Section 481 adjustment made necessary by the changes to the tax law in 1987.

1. They stated they incorrectly deducted $6,262,623 too much in 1988 for 1988 vacation pay accrual. Beginning 1-1-88, an employer was allowed to deduct as current expense only the amount of vacation pay accrual actually paid by 3-15 of the following year.
2. The taxpayer also stated they were entitled to an additional deduction in 1988 of $12,605,361 based on the Section 481 changes following the repeal of Section 463. This $12,605,361 was brought into income according to the percentages prescribed by law in 1988, 1989, 1990 and 1991.

LAW

The errors cited above will be addressed separately.

1. For tax years beginning before 1988, an accrual method employer could elect to deduct vacation pay that was paid during the tax year or within 8 1/2 months after the end of the year. Code Section 463, which permitted this election, was repealed for tax years beginning after 12-31-87. Beginning 1-1-88, an employer's deduction for vacation pay earned during the tax year will consist only of amounts paid during the year or within 2 1/2 months after year-end.

This taxpayer has stated its employees are not allowed to take vacation in the same year in which it is earned. Therefore, the only amount of the current year's accrued vacation pay which is deductible by the taxpayer is the amount actually paid to employees by 3-15 of the subsequent year. This adjustment is detailed in Item 3 on Page 4 attached.

2. A change from the reserve method of accounting for vacation pay to the method required under the 1987 Act is treated as a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary. The net amount of the adjustment required by the change in accounting method equals the excess of: (1) the amount in the vacation pay account as of the last day of the taxable year immediately preceding the taxable year of change over (2) the amount of accrued vacation pay as of the close of the taxable year immediately preceding the taxable year of the change that is paid within 2 1/2 months after the close of such taxable year. This amount is to be reduced by the balance in the suspense account as of the close of the taxable year immediately preceding the taxable year of change. This taxpayer has stated they did not have a suspense account.

When the entire amount of the adjustment is attributable to the tax year immediately preceding the year of change, the total adjustment is to be taken into account in computing taxable income for the year of change. The amount attributable to the tax year immediately preceding the year of change is the difference in the amount of the adjustment determined under Code Section 481(a) for the year of change and the amount of the adjustment that would have been required under Code Section 481(a) if the same change in method of accounting had been made for such preceding year. These calculations are detailed in Item 2 on Page 5 attached.

The taxpayer had incorrectly calculated the Section 481 adjustment as $12,605,361 when it actually should be $18,867,984. However, this is really inconsequential. Since this taxpayer had not maintained a Suspense Account under the prior law, the entire amount of the Section 481 adjustment is attributable to 1987. Therefore, the total amount is to be taken into account in computing taxable income for 1988. This adjustment is detailed in Items 1 and 2 on Page 4 attached.

However, in calculating the original Section 481 adjustment, the taxpayer determined the $12,605,361 should be brought into income over a four year period based upon percentages outlined in Section 481. This was in error and adjustments should now be made removing these amounts from taxable income. This adjustment is detailed in Item 1 on Page 4 attached.

Form 886-A (886A-97)	EXPLANATION OF ITEMS	Schedule No. or Exhibit
Name of Taxpayer	FPL Group, Inc. & Subsidiaries Subsidiary: Florida Power & Light Company	YEAR/PERIOD ENDED 1988-1992

CONCLUSION

The informal claim submitted by the taxpayer has been addressed and is being allowed. Taxable income is increased $3,111,283 in 1988, decreased $630,268 in 1989, and decreased $4,411,878 in both 1990 and 1991.

Effect of Section 481 Adjustments fn:97-PG2.SSF

	1988	1989	1990	1991
ACCRUED VACATION PAY				
Item 1				
Sec. 481 Adjustment - Year of Change				
Total Amount Taken Into Income				
As Reported	3,151,340	630,268	4,411,878	4,411,878
As Corrected	18,867,984	0	0	0
Adjustment	15,716,644	(630,268)	(4,411,878)	(4,411,878)
Item 2				
Total Deduction Allowed				
As Reported	0			
As Corrected	18,867,984			
Adjustment	(18,867,984)			
Net Adjustment	(3,151,340)	(630,268)	(4,411,878)	(4,411,878)
Item 3				
Vacation Accrual - Reversal for Current Year				
Reversal as Reported	19,513,784			
Reversal as Corrected	25,776,407			
Adjustment	6,262,623			
Total Net Adjustments	3,111,283	(630,268)	(4,411,878)	(4,411,878)

Section 481 Adjustments
fn:886A-97.ssf

FPL Group, Inc. & Subsidiaries
Entity: Florida Power & Light Company

	1987	1988	1989
Item 1			
Accrued Vacation Pay	27,650,680	29,023,256	31,107,276
Paid by 9/15/88	21,844,037		
Reversal - Current Year	5,806,643		
Paid by 3/15/89		3,246,849	
Reversal Current Year		25,776,407	
Paid by 3/15/90			3,810,103
Reversal Current Year			27,297,173
Item 2			
Section 481 Adjustments			
Accrued Vacation Pay	27,650,680		
Paid by 3/15/88	2,976,053		
Reversal - Current Year	24,674,627		
Reversal - Current Law	24,674,627		
Reversal - Prior Law	5,806,643		
Section 481 Adjustment	18,867,984		
Deduction - Prior Law	21,844,037		
Deduction - Current Law	2,976,053		
Section 481 Adjustment	18,867,984		

(6)

Page 5

54-4

Substitute for Form 5701

Department of the Treasury - Internal Revenue Service

NOTICE OF PROPOSED ADJUSTMENT

TIP COPY

Name and Address of Taxpayer

FPL GROUP, INC. & SUBSIDIARIES FPL GROUP, INC. - TAX DEPT.
P.O. BOX 000001

NORTH PALM BEACH FL 33408

S.S.N. or E.I.N.: 59-2449419

Issue No: 0055

Date Issued: 11/3/94

Entity No: 000002 Entity: FLORIDA POWER & LIGHT COMPANY

Proposed By: TIM LINDSEY Title: REVENUE AGENT

Submitted To: BOB CHESHIRE Title: TAX DEPARTMENT Response Due: 12/8/94

Authorized Representative's Action:
__Agree __Agree In Part __Disagree __Have Additional Information; Will Submit By _____

James C Haggerty Vice Pres, Tax 1/10/95
Authorized Signature Title Date

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Year	Issue Raised	Category	Amount	
8812	OTHER INCOME - CIDC	INC/DEC TAXABLE INCOME	(3,929,056.00)	54-F p 1
8912	OTHER INCOME - CIDC	INC/DEC TAXABLE INCOME	3,115,647.00	
9012	OTHER INCOME - CIDC	INC/DEC TAXABLE INCOME	4,901,307.00	
9112	OTHER INCOME - CIDC	INC/DEC TAXABLE INCOME	2,282,368.00	54-F p 2
9212	OTHER INCOME - CIDC	INC/DEC TAXABLE INCOME	3,900,655.00	

For Explanation Of Items See Attached Pages

Case Manager - JUDY HERRON

11/9/94
Date

Confidential (1)

Page 1
Form CS5701

WP 54-4/3

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit 5701-055.MPF
Name of Taxpayer FPL Group, Inc. and Subsidiaries Subsidiary: Florida Power & Light Company		Year/Period Ended 1988 - 1992

Other Income - Contributions In Aid Of Construction

	1988	1989	1990	1991	1992
Adjustment to Income (decrease)	$(3,929,356)	$3,115,647	$4,984,307	$2,282,368	$3,900,655

ISSUE

What is the correct amount to be reported by Florida Power & light Company in the tax years 1988 - 1992 as contributions in aid of construction (CIAC)?

FACTS

Part of the adjustments shown above arise from an informal claim filed by the taxpayer with the Internal Revenue Service.[1] Florida Power & Light Company is a subsidiary which files with the consolidated group under the parent company - FPL Group, Inc. When the taxpayer filed the original consolidated federal corporate income tax returns for the years 1988 - 1991, the amount of the contributions in aid of construction that was reported was overstated in some years and understated in other years, according to the informal claim. When the taxpayer filed the amended 1992 corporate tax return, a revision was also made to the amount of taxable CIAC that was originally reported.

Florida Power & Light Company maintains a system of power lines that is designed to deliver electricity to customers. This system consists of several different types of power lines with specific functions. High-voltage transmission lines carry electricity from the power plant to the taxpayer's various substations. The voltage is cut by a transformer at the substation and the electricity is generally carried along a distribution line to the vicinity of the customers. A service line is generally used to connect the individual customer to the utility's distribution line. This connection is generally referred to as a "service drop".

In order to be connected to the taxpayer's power distribution system, the customer may have to pay a nonrecurring fee to cover the cost of extending

---

[1] The informal claim consisted of a schedule that was prepared by Florida Power & Light Company's tax department entitled 1988 - 1992 CIAC Calculations, along with several supporting schedules.

the power line. Most often only a service line is needed but occasionally a distribution line must be installed for larger projects such as subdivisions, manufacturing plants, or commercial buildings.

Customers usually have a choice in selecting the manner that power will be delivered to their property. The primary method of delivering service to the customer is known as "Standard Overhead Service". This involves overhead power lines that connect directly to the residence or building. This type of service generally does not involve any charge to the customer. If, however, (1) underground service is requested, (2) the length of the service drop is greater than the "standard length", or (3) the estimated cost to connect the customer's line to taxpayer's power lines is greater than three times the estimated annual Kilowatt Hour (KWH) sales over the new line, a one time fee, based upon tariff charges approved by the Florida Public Service Commission (FPSC), may be charged. These one time fees are classified by the Commission as Contributions in Aid of Construction.

LAW

Section 118(b) of the Internal Revenue Code of 1954 provided a special rule for contributions in aid of construction received by regulated public utilities providing certain services. Under this rule, contributions in aid of construction were treated as contributions to capital and were therefore excluded from gross income under section 118(a). Section 824 of the Tax Reform Act of 1986 (Pub. L. No. 99-514) changed the treatment of amounts received as contributions in aid of construction after December 31, 1986, in taxable years ending after such date.

New section 118(b) of the Internal Revenue Code of 1986 expressly provides that contributions in aid of construction and other contributions made by a customer or potential customer (collectively, "CIACs") are not contributions to capital and thus are not excluded from gross income under section 118. Accordingly, such amounts are required to be included in gross income under section 61.

Notice 87-82

On December 21, 1987, the IRS released Notice 87-82,[2] which discussed several issues involving CIACs and the change in Section 118. Section II of Notice 87-82 deals with relocation of utility facilities. This has particular relevance to the instant case because the taxpayer is claiming exemption from taxation for significant amounts of relocation fees received.

---

[2] Notice 87-82, Regulated Public Utilities - Contributions in Aid of Construction After Tax Reform, 1987-2 C.B. 389.

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit 5701-055.WPT
Name of Taxpayer FPL Group, Inc. and Subsidiaries Subsidiary: Florida Power & Light Company		Year/Period Ended 1988 - 1992

Section II of the Notice states:

II. Relocation of Utility Facilities

The Internal Revenue Service has received numerous inquiries regarding the Federal income tax treatment under the 1986 Code of fees and other amounts received by utilities for relocating utility facilities ("relocation fees"). Frequently, utilities are required to relocate utility facilities in order to accommodate a public right-of-way. For example, a utility line may have to be relocated in order to allow for the construction or improvement of a public highway. Similarly, overhead utility lines may be placed underground under a governmental program undertaken for reasons of community esthetics and public safety. In such cases, the utility typically receives, directly or indirectly, a relocation fee in reimbursement for the costs of relocating the utility facilities. The legislative history to section 824 of the Act indicates that Congress viewed the receipt by utilities of CIACs as a prepayment for future services that the utilities would provide to their customers. H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 643-45 (1985) ("House Report"). Congress viewed the exclusion of these amounts from income as inappropriate and accordingly, required that a utility

> report as an item of gross income the value of any property, including money, that it receives to provide, or encourage . . . the provision of, services to or for the benefit of the person transferring the property. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of services, if the receipt of the property results in the provision of services earlier than would be the case had the

> property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.

House Report at 644.

The legislative history to the Act also indicates that a

> person transferring the property will be considered as having been benefited [from such transfer] if he is the person who will receive the [utility] services, an owner of the property that will receive the services, a former owner of the property that will receive the services, or if he derives any benefit from the property that will receive the services. Thus, a builder who transfers property to a utility in order to obtain services for a house that he was paid to build will be considered as having benefited from the provision of the services . . . despite the fact that the builder may never have had an ownership interest in the property and may make the transfer to the utility after the house has been completed and accepted.

House Report at 644-45.

In contrast, the legislative history to the Act provides that the repeal of section 118(b) of the 1954 Code does not affect transfers of property which are not made in connection with the provision of services, including situations where "it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers." Id. (emphasis added)

Based on the foregoing, the Federal income tax treatment of many types of relocation fees has not been affected by section 824 of the Act. If, for example, it can be shown that a particular payment received by a utility does

or by a governmental entity) to pay the utility for the costs of relocating utility facilities in order to obtain access to utility services for a site the customer is developing. Since the payment of the relocation fees is a prerequisite to obtaining utility services, the payment is a CIAC and is included in the utility's income, regardless of whether the particular utility facilities being relocated are related to the site the customer is developing. Relocation fees are treated as CIACs and included in gross income if such payments relate to the provision of services by the utility, regardless of the status or identity of the customer from whom the fees are received. For example, assume a utility receives a payment relating to the relocation or extension of utility facilities to a newly constructed municipal building (e.g., a public hospital, civic center, or museum) whose operations are conducted for the benefit of the community at large. Assume also that payment of the relocation fee was required in order to obtain utility services for the new building. Since the relocation fee is a prerequisite to the provision of services to the customer, the fee is a CIAC and included in gross income even though the customer is exclusively engaging in activities for the public benefit. Similarly, payments that are made to a utility as a prerequisite to the utility providing new or additional services to particular customers are treated as CIACs and included in gross income because such payments are a prerequisite to the provision of services by the utility, although a governmental entity may be making the payments in question. (emphasis added)

Several of the situations highlighted in Notice 87-82 were encountered in the instant case. The taxpayer provided documentation (work orders, etc.) that described the work in sufficient detail to establish that they were entitled to exclude certain work orders from income even though they were CIACs. For example, the taxpayer initially did not exclude a significant number of work orders where the work performed was solely to relocate utility lines to accommodate the expansion of a public roadway. Those expenditures have been allowed as part of the informal claim.

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit 5701-055.WPT
Name of Taxpayer FPL Group, Inc. and Subsidiaries Subsidiary: Florida Power & Light Company		Year/Period Ended 1988 - 1992

There were also several situations where the taxpayer excluded work orders from income that should have been included because they were actually CIACs. Those work orders were initially determined to be public benefit items as described in Notice 87-82 but upon examination were found to be normal CIACs and therefore not eligible for exclusion.

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit 1981-1987
Name of Taxpayer FPL Group, Inc. and Subsidiaries Subsidiary: Florida Power & Light Company		Year/Period Ended 1988 - 1992

CONCLUSION

The adjustments in the amounts shown above are required to correct the total amount of income from contributions in aid of construction for the tax years 1988 - 1992. A corresponding adjustment for depreciation will be made and included as a separate issue. Other adjustments will be required to correct taxable income for jobs that were erroneously reported on the returns.

Form 5701 NOTICE OF PROPOSED ADJUSTMENT

Name and Address of Taxpayer S.S.N. or E.I.N.: 59-2449419 Issue Act 0017
FPL GROUP, INC. & SUBSIDIARIES FPL GROUP, INC. - TAX DEPT.
P.O. BOX 000001 Date Issued: 10/22/93

NORTH PALM BEACH FL 33408

Entity No: 000002 Entity: FLORIDA POWER & LIGHT COMPANY

Proposed By: MARIA CUADRO Title: REVENUE AGENT

Submitted To: BOB CROSBIE Title: TAX DEPARTMENT Response Due: 11/05/93

Authorized Representative's Action:
X Agree __Agree in Part __Disagree __Have Additional Information: Will Submit By: ____

James C. Higgins V.P. Tax 1/12/94
Authorized Signature Title Date

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Year	Issue Raised *	Category	Amount
8812	OTHER INCOME - CUSTOMER DEPOSITS	INC/DEC TAXABLE INCOME	(5,324,303.00)
8912	OTHER INCOME - CUSTOMER DEPOSITS	INC/DEC TAXABLE INCOME	(2,660,618.00)
9012	OTHER INCOME - CUSTOMER DEPOSITS	INC/DEC TAXABLE INCOME	(2,660,619.00)

SF-4

For Explanation Of Items See Attached Pages

Case Manager: [signature] 11/3/93
Date

Confidential (1) Page 1 Form C65701

WP 54-4/4

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit F5701-17
Name of Taxpayer GROUP, INC. FLORIDA POWER & LIGHT		Year/Period Ended 1988-1992

CUSTOMER DEPOSITS

	1988	1989	1990
Adjustment to Income:	<$5,324,303>	<$2,660,618>	<$2,660,619>

ISSUE:

Whether customer deposits received by the taxpayer to ensure payment of bills is income upon receipt.

FACTS:

Florida Power & Light is a public utility engaged in the generation of electricity and uses the accrual method of accounting. Under this method of accounting the taxpayer included customer security deposits in income pursuant to Reg. 1.451-5(c).

In 1991, the taxpayer filed a request for change in accounting method under Revenue Procedure 84-74 invoking the terms and conditions specified under Revenue Procedure 91-31. The request was for exclusion of customer deposits from taxable income. The year of change was the year beginning January 1, 1985. The IRC Section 481(a) adjustment to be spread over six years was $15,963,709.

For tax year 1988, the taxpayer made a Schedule M-1 entry of $2,663,685 for taxable customer deposits.

The amounts resulting from the change in accounting method are as follows:

Years	IRC Sec. 481 Adj.	Reverse Sch. M-1	Total
1985	$ 2,660,618	$ 1,622,649	$ 4,283,267
1986	2,660,618	1,129,435	3,790,053
1987	2,660,618	<23,681>	2,636,937
1988	2,660,618	2,663,685	5,324,303
1989	2,660,618	0	2,660,618
1990	2,660,619	0	2,660,619
Totals	$15,963,709	$ 5,392,088	$21,355,797

LAW:

The Supreme Court rendered judgement on January 1990, relating to the customer deposit issue in the Indianapolis Power & Light, Co., 493 US 203 (1990) case. The court stated that customer deposits were not advance payments for electricity and therefore do not constitute taxable income.

TAXPAYER'S POSITION:

The taxpayer is in agreement with this issue.

Form 886-A	EXPLANATION OF ITEMS	Schedule No. or Exhibit F5701-17
Name of Taxpayer GROUP, INC. FLORIDA POWER & LIGHT		Year/Period Ended 1988-1992

CONCLUSION:

Pursuant to the court decision, the change in accounting method is allowed. The taxpayer's taxable income is being reduced by the customer deposit amounts previously included.