KINGSLEY SERVICE COMPANY
782 FOXRIDGE CENTER DRIVE
ORANGE PARK, FLORIDA 32065
(904) 272-5999

June 27, 1991

ORIGINAL
FILE COPY

Mr. Steve Tribble, Director
Division of Records and Reporting
Florida Public Service Commission
Fletcher Building
101 East Gaines Street
Tallahassee, Florida 32399-0870

Re: Transmittal of exhibits which were apparently erroneously omitted from the "Petition of Kingsley Service Company for Declaratory Statement related to appropriate treatment of taxes related to CIAC", Docket No. 910531-WS, dated 4/30/91.

Dear Mr. Tribble:

Ms. Rhonda Hicks of the tax department called this afternoon and said that we had failed to include Exhibits "A" and "B" on the above referenced filing, which was mailed from our office on April 26, 1991.

In this regard, we are enclosing herewith the original and fifteen copies of the exhibits that should have been attached to that petition.

Please advise if you have any questions or require any additional information in this regard.

Very truly yours,
KINGSLEY SERVICE COMPANY

Ray O. Avery

ROA/cb
Enclosure

cc: Ms. Rhonda Hicks

ACK ✓
AFA 1
APP 1
CAF
CMU
CTR
EAG
LEG
LIN
OPC
RGH
SEC 1
WAS
OTH

1988 Note (Payments)	Note Balance 12/31/88	1989 Note Rescissions & CDAC Refunds	1989 Note (Payments)	Note Balance 12/31/89
0.00	0.00	0.00	0.00	0.00
0.00	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
0.00	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
883.49	0.00	0.00	0.00	0.00
3,732.82	78,511.75	0.00	(78,511.75)	0.00
0.00	149,800.00	0.00	0.00	149,800.00
0.00	0.00	0.00	0.00	0.00
(119,927.79)	(.00)	0.00	0.00	(.00)
2,571.00	(.00)	0.00	0.00	(.00)
3,262.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
0.00	24,483.02	0.00	0.00	24,483.02
0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
687.68	2,638.24	0.00	(2,638.24)	0.00
355.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
(30,409.99)	64,541.02	(10,571.83)	(53,969.18)	0.00
(140,306.55)	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
(133,385.48)	0.00	0.00	0.00	0.00
(14,769.57)	0.00	0.00	0.00	0.00
(20,050.04)	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
(6,105.60)	0.00	0.00	0.00	0.00
4,750.00	(.00)	0.00	0.00	(.00)
84.50	(.00)	0.00	0.00	(.00)
0.00	(.00)	0.00	0.00	(.00)
(115,242.26)	0.00	0.00	0.00	0.00
(507,639.48)	34,595.74	(17,836.34)	(16,759.40)	0.00
0.00	0.00	0.00	0.00	0.00
12,415.00	0.00	0.00	0.00	0.00
(101,446.16)	0.00	0.00	0.00	0.00
(1,996.75)	0.00	0.00	0.00	0.00
1,065.00	(.00)	0.00	0.00	(.00)
1,704.00	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
1.00	0.00	0.00	0.00	0.00
(1,034.00)	0.00	0.00	0.00	0.00
(1,191.25)	0.00	0.00	0.00	0.00
(196,918.25)	0.00	0.00	0.00	0.00
(97,132.92)	(12,405.25)	0.00	12,405.25	0.00
0.00	0.00	0.00	0.00	0.00
(14,263.97)	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
(191,584.30)	490,645.70	0.00	(490,645.70)	0.00
0.00	347,942.03	0.00	(98,485.97)	249,456.03
(139,083.07)	(.00)	0.00	0.00	(.00)
0.00	0.00	0.00	0.00	0.00
(21,320.92)	77,306.42	0.00	0.00	77,306.42
7,331.93	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00
(1,776,136.73)	1,258,058.62	(28,408.17)	(728,604.95)	501,048.47

RHY

Internal Revenue Service
memorandum

CC:JAX:TL-N-2357-91
WRMcCants:wrm

date: APR 10 1991

to: District Director, Jacksonville
Attn: Group Manager Craig McLaughlin
Group 1303, Stop 4303

from: District Counsel, Jacksonville

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subject: Kingsley Service Company
1279 Kingsley Avenue
Suite 120
Orange Park, Florida 32073

In December, 1990, you requested legal advice regarding certain contributions in aid of construction ("CIAC") received by the above taxpayer. Since that time, Revenue Agent Gale Downs has worked with this office in development of evidence underlying the issue. We appreciate the prompt and thorough assistance repeatedly rendered by Mr. Downs to this office over the last several months on the CIAC issue. Based on facts developed by Mr. Downs, it is our position that he is correct in treating the taxpayer's post-1986 receipts as taxable contributions in aid of construction, and in disregarding the "Demand Notes" received in December, 1986, in an attempt by the taxpayer to accelerate the CIAC as nontaxable 1986 contributions to corporate capital.

Kingsley Service Company (the "taxpayer") is a state-regulated, private 1120 corporation supplying water utilities to areas of Clay County, Florida. According to one developer interviewed, only seven states have such privately owned utilities. In late 1986 the taxpayer learned from the Florida Public Service Commission ("FPSC") that the previously nontaxable CIAC would become taxable under a revised I.R.C. § 118 effective January 1, 1987, due to the recently enacted 1986 Tax Reform Act. FPSC suggested to private utilities that they consider accelerating CIAC they expected to receive after December 31, 1986, so that the amounts would be received before January 1, 1987, and not be taxed. The taxpayer is on the accrual basis of accounting.

The taxpayer obtained verbal advice from Jacksonville Attorney Fred H. Steffey that if the taxpayer received negotiable instruments from developers prior to January 1, 1987, the CIAC represented by the notes could be considered paid and received in 1986. This verbal legal advice, with conditions and clarifications, was confirmed in a letter issued almost one year later to the taxpayer by Attorney Steffey. We basically agree with Attorney Steffey's legal advice, but we believe the facts

surrounding Kingsley Service Corporation do not fit Attorney Steffey's conditions.

Acting on the FPSC information and the attorney's advice, the taxpayer and some 36 Clay County builders and developers on approximately 58 construction projects attempted to move prospective 1987 and 1988 CIAC into 1986. In the last week of 1986, these developers gave the taxpayer "Demand Notes" and executed contracts for the future water utility access and services. The contracts, but not the notes, were apparently recorded in the public records. The two contracts viewed by this office disclose official record book and page numbers.

Because of FPSC regulations and the December, 1986 contracts, the developers are responsible for ultimate payment of the taxpayer's tax liability arising from taxable CIAC. The relevant contract terms are as follows:

> The DEVELOPER shall pay the above sums by December 31, 1986. Any of the above amounts which are not received by the COMPANY prior to January 1, 1987, shall become subject to the provisions of the Tax Reform Act of 1986, which causes all Contributions in Aid of Construction to become taxable ordinary income to COMPANY. Also, any amounts by which the actual construction and/or plant and trunk main capacity charges (which are to be established at the time the final site engineering for paving, drainage and utilities is completed) exceeds the above referenced estimated charges, shall be due and payable to COMPANY within 30 days after the water and/or sewer installations have been completed for the Project. Such amounts, if received subsequent to December 31, 1986 shall become subject to the Tax Reform Act of 1986. Also, if the Project water and sewer system, provided for herein is not complete by December 31, 1988, then the entire prepayment shall be subject to income taxes to the COMPANY under the pre Tax Reform Act of 1986 provisions. In this regard, any such amounts that are (1) not received by COMPANY prior to January 1, 1987, whether such deficiency is caused by the (a) lack of a valid payment of the above referenced amounts by the DEVELOPER prior to January 1, 1987, and/or whether such deficiency is caused by (b) the under estimation of the construction costs and/or plant and trunk main capacity charges, and/or (2) the project water and sewer system is not completed by December 31, 1988, and such situations create an income tax liability for COMPANY by its acceptance of such Contributions in Aid of Construction, then DEVELOPER shall reimburse COMPANY for such resulting income tax liability to such extent

as may be allowed by the Florida Public Service Commission.

Permanent water and sanitary sewerage service to the lots in this development will not be initiated until the charges set forth in this paragraph are paid in full for this entire Project. If DEVELOPER fails to make timely payment within 30 days after receipt of a final settlement invoice in compliance with the above provisions (time being specifically made of the essence) it hereby grants to the COMPANY the right to charge interest on any amounts due and unpaid at the highest rate allowed by law computed from the due date until date of payment.

Under the arrangements made with the taxpayer in December of 1986, the taxpayer received demand notes and contracts regarding $7,461,721.17 in projected CIAC. Of this amount, roughly two-thirds, or just over $5,000,000.00, materialized in the form of expenditures by the taxpayer in 1987 and 1988 for the construction of additional utility facilities. It is our understanding that none of these amounts concerned non-CIAC "hook-up" or connection charges. The remainder of the $7,461,721.17, or about $2,300,000.00, was never expended since nine developments which had been projected in December, 1986 never materialized and some of the contracts cost less than the estimated amounts. The taxpayer forgave or "rescinded" this $2,300,000.00 in contracts and demand notes.

Prior to the December, 1986 transactions, the taxpayer had never required or solicited or accepted "Demand Notes." Since developers were helpless without access to water service, the taxpayer had simply billed the developers as the utilities were constructed, extended and provided. Prior to December, 1986, however, the taxpayer had utilized contracts very similar to the December, 1986 contracts, but without the "Demand Note" aspects. After December, 1986, the taxpayer reverted to its prior practice with all new developments. Only the 58 construction projects subject to the December, 1986 demand notes and contracts have ever involved such unique treatment.

The taxpayer did not negotiate any of the "Demand Notes." Instead, the taxpayer billed those developers as it had previously (and as it did afterwards), as facilities became complete. The only difference seems to have involved the requirement that the developers pay the interest due on the December, 1986 note amounts. Payment of this interest by the developers was considerably less expensive than if the developers had to compensate the taxpayer for taxable CIAC in 1987 and 1988. (The developers figured it was 9.5% interest versus a 58% "gross-up," so the interest was much less onerous.)

Revenue Agent Downs contacted six of the developers in late March, 1991, to get better details of the circumstances underlying the demand notes. None had signed such notes before or since the isolated December, 1986 transactions. All six treated their "Demand Note" as a promissory note to be paid when the utilities were constructed. All six stated they would have had to borrow money in order to pay the demand notes had the notes been "called" by the taxpayer. One developer said it would have put him out of business if the taxpayer had called the note. Another stated the note was provided to avoid having to pay money "up front." Only one of the developers ever listed the demand note as a liability on a return or financial statement, and that was because the developer had undergone a certified audit.

Mr. Downs prepared two graphs at our request, copies of which are attached hereto. One graph shows CIAC as reported by the taxpayer, with astronomical 1986 CIAC and almost nonexistent CIAC for 1987 and 1988. The second graph ignores the December of 1986 "Demand Notes" and places CIAC in 1987 and 1988 as the developers were actually charged for the improvements. This second graph, which should be roughly consistent with the income adjustments Revenue Agent Downs will propose, shows 1986 and 1987 CIAC as equal, and a somewhat diminished CIAC for 1988 as construction demand began to lag.

Under the facts set forth above, we agree with Revenue Agent Downs that the notes were aberrations brought about by the 1986 Tax Reform Act, that the substance of the transactions should prevail over the form, and that including the notes in 1986 would be a distortion of income and an unauthorized change in accounting method.

In the taxpayer's favor, the taxpayer received facially enforceable demand notes and binding contracts, apparently prior to the end of 1986. Our representative copy of the note is dated December 31, 1986 (a Wednesday). The notes did not refer to any related contracts, conditions, or obligations to be performed by Kingsley Service Company. The contracts expressly provided for prepayment. Also, the notes provided for interest which the taxpayer required the developers to pay.

Against the taxpayer are the following factors, we believe:

1. The notes were solely tax-motivated.

2. The December, 1986 transactions were clearly aberrations. The taxpayer never previously or subsequently used such devices.

3. The demand notes were never negotiated.

4. The contemporaneous contracts, which were apparently publicly recorded, constitute the prohibited kind of "other agreements, such as the agreements concerning the furnishing of water and sewer disposal services to property owned by the makers of the notes and the construction of the additions to the Company's systems needed therefor, (which) would restrict the Company's rights under the notes." (As described on page 8 of Attorney Steffey's letter opinion.) As the notes were to Kingsley (not "bearer") and as the contracts were publicly recorded, we question the ability of a independent purchaser to have relied on the negotiability of the notes, and to qualify as a holder in due course.

5. The developers treated the notes as promises to pay or deposits, not payments. None of the developers understood any right or ability of Kingsley Service Corporation to "call" the notes. Had Kingsley called the notes in late December, 1986, the developers would have had to borrow money to pay the notes, or would probably have contested Kingsley's right to prepayment. Assuming the developers had needed financing to pay Kingsley, we think the developers would have: (a) litigated Kingsley's right to payment under the note; (b) not paid Kingsley until their loan closed in 1987, at the earliest; (c) switched utilities; or (d) gone out of business.

6. Almost one third of the notes and contracts were forgiven or rescinded when the developments failed to materialize. Anyone who wanted to retrieve their note and contract was apparently able to do so as long as Kingsley had not expended funds. If Kingsley had already expended some funds for the project, we believe Kingsley would have cancelled the note if reimbursed for its expenses to date. This casts considerable doubt on the binding nature of the December, 1986 arrangements, and the extent to which they should be recognized. We wonder if Kingsley would have been as eager to recognize in 1986 the $2,300,000.00 in notes which were ultimately rescinded (or any other notes), had they constituted taxable income in 1986.

7. Apparently, some of the December 1986 arrangements already involved existing contracts between Kingsley and the developer. Perhaps the developments which were in advanced stages of construction by December, 1986 were previously contracted. Note, for instance that the bill to Landem Development Corporation for "Heritage Hills, Unit 6" refers to "our Water and Sewer Agreement dated 6/20/86." Yet Heritage Hills, Unit 6 involved a demand note for $168,988, presumably executed and provided in December, 1986. The contract with Heritage Farms Development Company similarly refers to a prior payment of $28,200.00 and a "Master Agreement" dated June 18,

1985. We believe multiple contracts with the same developer for the same project diminish the legitimacy of the duplicative contracts entered in late December, 1986.

8. The taxpayer's method of accounting for CIAC before and after the December, 1986 transactions was to accrue the payment receivable only when the facilities were constructed and the developer was billed. The taxpayer continued the billing practice with developers under the December, 1986 contracts and demand notes in the same way by requiring payments in 1987, 1988 and 1989 as the utility facilities were constructed. The only difference, in substance, between the December, 1986 transactions and all other transactions was the interest charged to the developers who had executed the demand notes.

Normally it is the government, not the taxpayer, who attempts to accelerate the reporting of income. A taxpayer usually seeks to defer income. Because of this, most cases requiring the inclusion of income represented by the receipt of a negotiable instrument or demand note did so at the government's urging. It is not easy to find situations where the Internal Revenue Service recommends deferral of income when the taxpayer has received an apparent negotiable instrument as "payment" and seeks to include it as a receipt at an early date.

The Supreme Court has held that an accrual-basis taxpayer is required to treat advance payments for future services, received without restrictions as to their use, as income in the year of receipt. See Schlude v. Commissioner, 372 U.S. 128, 83 S.Ct. 601 (1963); American Automobile Assn. v. United States, 367 U.S. 687, 81 S.Ct. 1727 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 77 S.Ct. 707 (1957). However, if the payment constitutes a "loan," no income is realized at the time of receipt. United States v. Ivey, 414 F.2d 199 (5th Cir. 1969). If the advance payment is instead a "deposit," and there is no guarantee the taxpayer will be allowed to retain it, the amount is not taxable when received (if ever), despite the taxpayer's interim dominion and control over the money. Commissioner v. Indianapolis Power & Light Co., ____ U.S. ___, 110 S.Ct. 589 (1990).

We believe that the demand notes received by Kingsley Service Company in December, 1986, as encumbered by contract terms and understandings with the developers, as often rescinded when a development did not materialize, as retained instead of pledged, assigned or negotiated by Kingsley, and as ignored in deference to the regular progress payment billing schedule Kingsley has always practiced, did not constitute "payments" in 1986. Also, from the discussions with the developers, it appears the notes were not readily enforceable nor the obligors necessarily sufficiently solvent to satisfy the notes in 1986. Even if the notes were payments or deposits in 1986 (which we contest), we do not believe

all events had occurred in 1986 so as to fix the taxpayer's right to receive the income, or to determine the amount of such income with reasonable certainty. Treas. Reg. § 1.451-1(a). There were simply too many uncertainties, contingencies and restrictions outside of Kingsley's control to recognize the notes in 1986.

Further, we do not believe the factual circumstances support inclusion of the note amounts in 1986 under the taxpayer's method of accounting. Section 446(a) of the Internal Revenue Code provides the general rule for methods of accounting. Section 1.446-1(a)(1) of the Income Tax Regulations provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A "material item" is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A change in treatment resulting from a change in underlying facts is not a method change. We do not consider the December, 1986 transactions to have created a change in underlying facts. We do consider the CIAC to be a material item.

Assuming the taxpayer changed its method of accounting, it had to first obtain the Commissioner's permission. I.R.C. § 446(e); Chicago & Northwestern Ry. v. Commissioner, 114 F.2d 882, 887 (7th Cir. 1940), cert. denied, 312 U.S. 692 (1941). Since it did not do so, no such change should be recognized and the income should be included in the years 1987, 1988 and 1989, when it properly accrued.

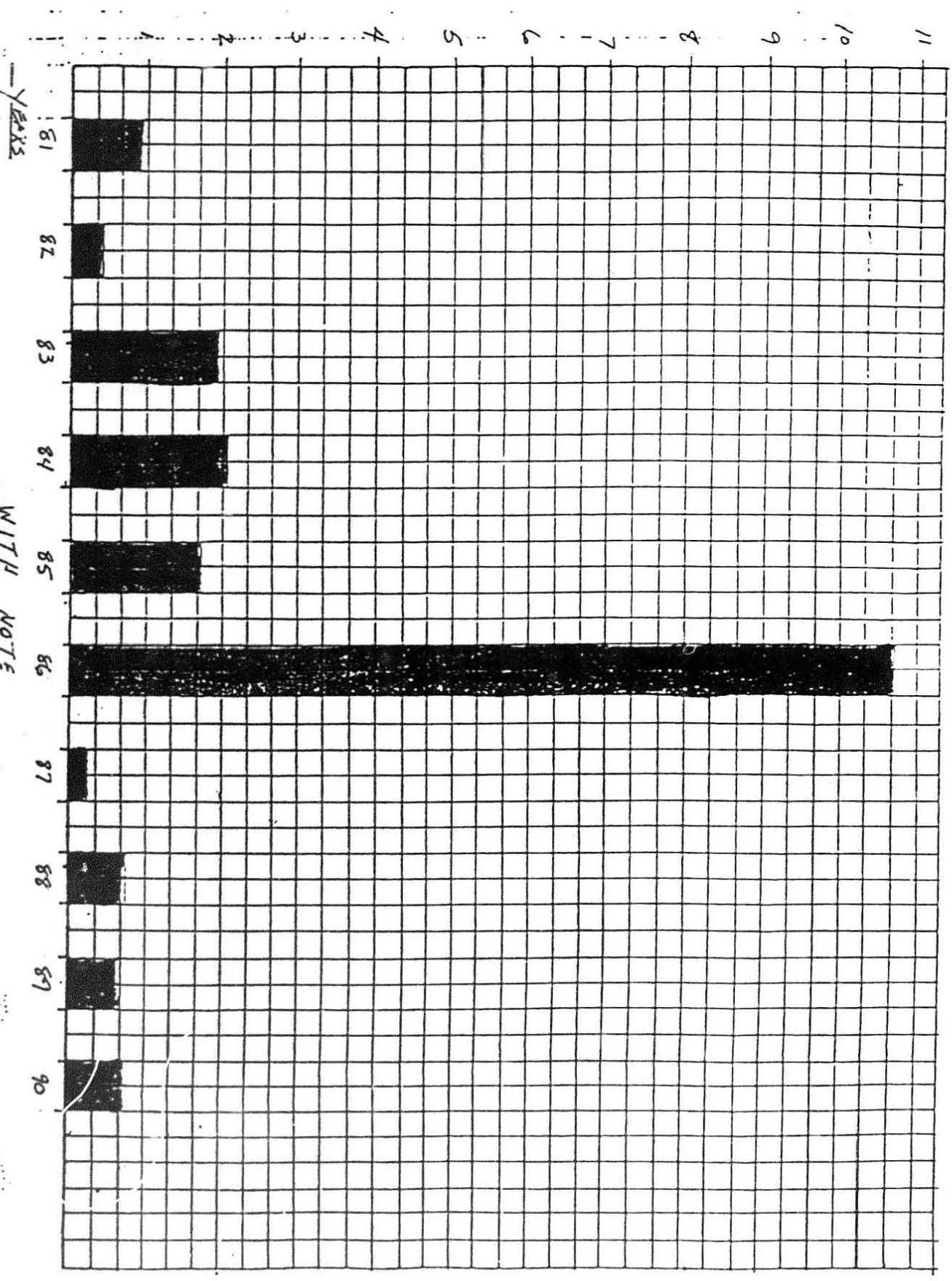
In summary, we believe the attempt to accelerate CIAC into 1986 distorted income, improperly elevated form over substance, prematurely accrued the CIAC, and constituted an impermissible change in accounting method.

Mr. William R. McCants of this office may be reached at (FTS) 946-2383.

BENJAMIN A. de LUNA
District Counsel

WILLIAM R. McCANTS

By: _____
WILLIAM R. McCANTS
Special Litigation Assistant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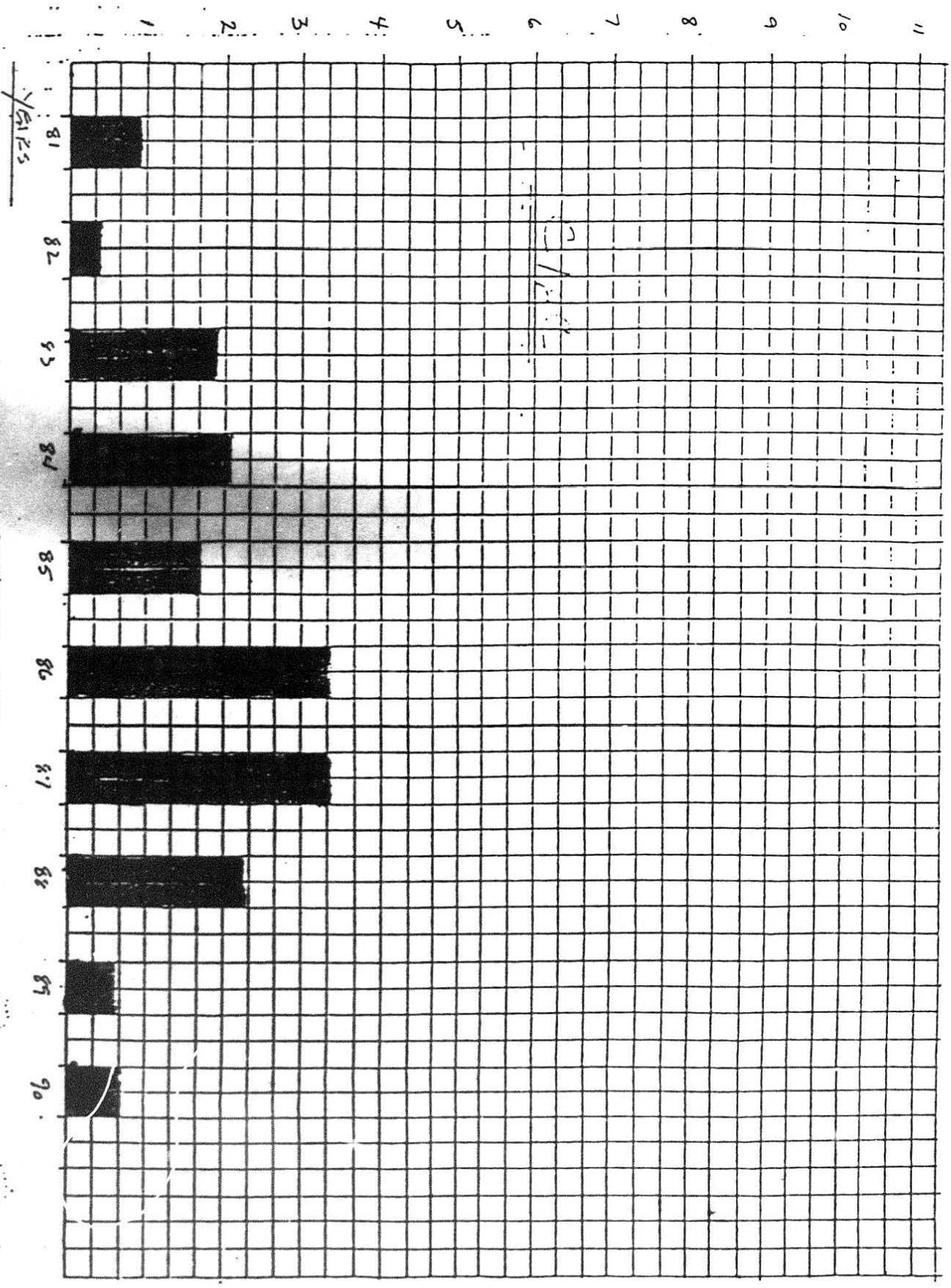
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