Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B06 – PLR-129357-03
May 3, 2004

In Re:

Legend:

Taxpayer =
Target =
Buyer =
Seller =
Purchase Date =
Parent =
Date 2 =

Dear :

This letter responds to Taxpayer's request, dated , for a ruling concerning the consequences under former section 167(l), former section 46(f), and section 168(i)(9) of the Internal Revenue Code of the deemed acquisition of the assets of a regulated natural gas pipeline and natural gas storage business.

Taxpayer represents that the facts are as follows:

On Purchase Date, Buyer acquired the stock of Taxpayer from Seller. Buyer's stock acquisition constituted a "qualified stock purchase" within the meaning of section 338(d)(3), and Buyer and Seller made a timely joint election under section 338(h)(10) for Taxpayer. Thus, the "new" Target, or Taxpayer, owned by Buyer was deemed to have purchased all of the "old" Target assets for an amount equal to the consideration paid for Taxpayer's stock plus the amount of the old Target's liabilities. As a result of this transaction, new Target took a tax basis in its assets computed by reference to Buyer's purchase price rather than by reference to the historical basis of those assets. Immediately prior to this purchase, Taxpayer reflected on its regulatory books of account approximately $ of property-related accumulated deferred federal income tax (ADFIT) and $ of accumulated deferred investment tax credit

(ADITC). There was no remaining excess deferred federal income tax (EDFIT) balance as of the purchase date.

On Date 2, Parent acquired Taxpayer from Buyer. Parent paid cash for the stock of Taxpayer. No election was made under section 338. Thus, the tax basis of the assets owned by Taxpayer was not affected by this stock purchase transaction. Since Date 2, Taxpayer did not petition the FERC to re-set its Base Tariff Rates. Thus, the Base Tariff Rates in effect immediately prior to the acquisition of Taxpayer's businesses remained in effect.

As a result of these transactions, Taxpayer employed certain "post-acquisition" accounting for purposes of FERC to reflect normalization requirements. Specifically, upon the deemed asset acquisition from old Target on Acquisition Date, Taxpayer eliminated from its regulatory books of account both the ADFIT and the ADITC balances that old Target had reflected. This has resulted in an increase in Taxpayer's rate base and moreover a decrease in Taxpayer's net income. Also, Taxpayer has determined not to seek a new rate determination to reflect its changed circumstances.

In light of the foregoing, Taxpayer has requested a ruling on whether Taxpayer will be using a normalization method of accounting if, immediately upon its deemed purchase of public utility assets, it eliminates all ADFIT and ADITC balances associated with public utility property from its regulatory books of account such that those balances are not thereafter used for establishing cost of service for ratemaking purposes nor for reflecting operating results in Taxpayer's regulated books of account, and also whether Taxpayer need not participate in a rate proceeding recognizing the elimination of these balances in order to comply with the normalization rules.

ADFIT Balances

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) generally provided that public utilities were entitled to use accelerated methods of depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1 if the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the tax year in which the different methods of depreciation are used.

Section 1.167(l)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes shall not be reduced except to reflect the amount for any tax year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

Section 338(a) of the Code provides that, if the stock of a corporation ("target corporation") is acquired by another corporation ("purchasing corporation") in a qualified stock purchase, the purchasing corporation may elect to have the purchase of the target corporation's stock treated as if the target corporation sold all of its assets (as "old target") at the close of the acquisition date at fair market value in a single transaction. The target corporation then is treated as a new corporation that purchased those same assets (as "new target") as of the beginning of the day after the acquisition date.

If, before the stock purchase, the target corporation is a member of an affiliated group that files a consolidated return for the tax year within which the transaction takes place, section 338(h)(10) of the Code provides an election under which tax liability of the target corporation from the deemed sale of its assets is included in the consolidated return of the selling consolidated group ("selling group"). This election is made jointly by the purchasing corporation and the selling group pursuant to section 1.338(h)(10)-1(c) of the Income Tax Regulations.

The consequences of a section 338(h)(10) election are provided in section 1.338(h)(10)-1(d) of the regulations. Under section 1.338(h)(10)-1(d)(3), old target recognizes gain or loss as if, while a member of the selling group, it sold all of its assets in a single transaction as of the close of the acquisition date. Section 1.338(h)(10)-1(d)(5) further provides that, at the close of the acquisition date but after the deemed sale of assets, old target is treated as if it distributed all of its assets in a complete liquidation to which section 331 or 332 of the Code applies. Thus, the primary effect of a section 338(h)(10) election is a deemed taxable sale by target corporation of all its assets followed by a deemed complete liquidation under section 331 or 332.

In the present situation, Buyer purchased all of stock of Taxpayer, or Target, from Seller, and Buyer and Seller made a joint election under section 338(h)(10) of the Code for Target. This election results, for federal income tax purposes, in a deemed taxable sale of assets by Target (as old Target) to itself (as new Target) in a taxable transaction. Because of this sale, old Target's deferred tax reserve relating to accelerated depreciation is reduced under section 1.167(l)-1(h)(2)(i) of the regulations to reflect the retirements of old Target's assets. After the application of section 1.167(l)-1(h)(2)(i), old Target's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the deferred tax reserve resulting from accelerated depreciation should be removed from old Target's regulated books of account and not flowed through to the customers of new Target, or Taxpayer.

ADITC Balances

Section 46(f) provides that no investment credit determined under section 46(a) shall be allowed by section 38 with respect to any public utility property of the taxpayer (a) if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the investment credit, or (b) if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the investment credit.

Section 1.46-6(a)(3) of the regulations provides that the provisions of section 46(f)(2) of the Code are limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. If an election is made under section 46(f)(2), the credit may be flowed through to income, but not more rapidly than ratably, and there may not be any reduction in rate base.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Under section 1.46-6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense" means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

Section 46(f)(7) of the Code provides that if by reason of a corporate reorganization or by reason of any other acquisition of the assets of one taxpayer by another taxpayer, the application of any provisions of section 46(f) to any public utility property does not carry out the purposes of section 46(f), the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of section 46(f).

According to section 46(f)(10)(A) of the Code, one way in which the requirements of section 46(f)(2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under section 46(f)(10)(B), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's qualified investment for purposes of the investment credit allowable by section 38 unless such estimate or projection is also used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

Any public utility that claims the investment credit for public utility property must use "normalization" accounting in calculating the rates to be charged to its customers and in maintaining its regulated books of account. Under normalization accounting, the immediate flow-through of the investment credit for public utility property to the utility's customers is prohibited. Instead, under section 46(f)(2) of the Code, for ratemaking purposes the utility defers the investment credit it clarified for Federal income tax purposes and then amortizes the deferred balance ratably over the regulatory life of the assets generating the credit.

In a taxable sale of assets, the purchaser does not “step into the shoes” of the seller and as a result, any investment credit associated with the assets do not carryover from the seller to the purchaser. Instead, the purchaser receives the benefit of a new tax basis in, and a new placed in service date for, the property. This new basis and placed in service date determine the availability and the amount of the investment credit that the purchaser may claim for the acquired property. Except for certain transition property, property placed in service by a taxpayer after 1985 is not eligible for the investment credit.

In the present situation, Buyer acquired the stock of Taxpayer from Seller, and Buyer and Seller made a joint election under section 338(h)(10) of the Code for Taxpayer. This election results, for federal income tax purposes, in a deemed taxable sale of assets by old Target to new Target. New Target does not step into the shoes of old Target. Instead, new Target receives a new tax basis in, and a new placed in service date for, the assets deemed purchased from old Target. Consequently, the ADITC’s associated with old Target’s public utility property do not follow the property. Thus, these ADITC’s are not available to new Target for flow-through to its customers.

Further, new Target is not entitled to claim the investment credit for the property deemed purchased from old Target because the property is placed in service by new Target after 1985. Therefore, for such property, there is no investment credit claimed by new Target to reduce cost of service under section 46(f)(2) of the Code.

The normalization rules under section 46(f) of the Code contemplate that the utility may claim the investment credit for public utility property. Further, the legislative purpose underlying section 46(f) was to provide capital for investment in new equipment. If the ADITC’s related to old Target’s public utility property are ratably flowed through to cost of service, new Target would be flowing through to its customers an investment credit that is not available to, and was not claimed by, it. Consequently, new Target would receive no tax benefits of the investment credit while its customers would. Accordingly, an adjustment to cost of service for the ADITC’s of old Target would not be consistent with the purposes of section 46(f).

Further, the adjustment to cost of service for the ADITC’s associated with old Target’s public utility property would violate the consistency rules under section 46(f)(10) of the Code. Such an adjustment assumes that the qualified investment of new Target for purposes of the investment credit allowable under section 38 is equal to old Target’s qualified investment. However, section 46(f)(10)(B) clearly states that the taxpayer’s qualified investment must be used. In the present situation, Taxpayer is new Target. Because the investment credit has been repealed, none of the public utility property placed in service by new Target is eligible for the credit and consequently, its qualified investment is zero. Thus, an adjustment to the cost of service of new Target for the ADITC’s of old Target would violate the normalization requirements of section 46(f)(2).

New Rate Proceeding

When new Target, or Taxpayer, completed its deemed purchase of the subject assets from old Target on Acquisition Date, it succeeded to a rate tariff that had been established based on old Target's circumstances. This tariff had been established, at least in part, by reference to old Target's ADFIT and ADITC balances as well as the effects of the amortization of those balances on the tax expense element of cost of service. In Taxpayer's hands, those balances no longer exist – and cannot exist consistent with the normalization rules. Nor do any of the amortizations exist (and, again, they cannot consistent with the normalization rules). The issue is whether, consistent with the normalization rules, Taxpayer can succeed to the pre-existing Base Tariff Rate level, but not the impermissible structure on which that rate level was based.

In essence, Taxpayer has requested that the Service rule that the normalization rules do not require Taxpayer to initiate a rate proceeding recognizing the elimination of the ADFIT and ADITC balances. Based on the facts of this case, the normalization rules are not violated by the Taxpayer's decision not to seek a new rate determination. The Service does not generally determine such purely regulatory questions as to when rate proceedings are required or whether the determinations of a public utility commission will produce just and equitable rates.

No opinion is expressed regarding any Code section other than set out above. Further, no opinion is expressed concerning whether the section 338(h)(10) election made by Buyer and Seller for Taxpayer is a valid election.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

PETER FRIEDMAN
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for section 6110 purposes