Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
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Refer Reply To:
CC:PSI:B06 – PLR-128393-00

Date:
April 18, 2006

Re: Request for Private Letter Ruling Regarding Normalization

Taxpayer =

Parent =

State1 =
State2 =
Bill =
A =
B =
C =
D =
E =
F =
G =
H =
I =
J =

Dear :

This letter responds to a letter dated November 27, 2000, and supplemental information, submitted on behalf of Taxpayer for a determination as to the normalization requirements under former § 46(f)(2) of the Internal Revenue Code and § 203(e) of the

Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 (the "Act"), for the accumulated deferred investment tax credit ("ADITC") and excess deferred federal income taxes ("EDFIT") associated with certain generation assets that were sold by Taxpayer.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is an investor-owned public utility that has traditionally been engaged in the generation, transmission, and distribution of electric power. Taxpayer is subject to the regulatory jurisdiction of A with regard to its retail sales and certain conditions of service and to the regulatory jurisdiction of B with regard to its wholesale and wheeling rates. Taxpayer is a member of an affiliated group headed by Parent and files a consolidated federal income tax return with Parent.

Taxpayer made the election to use the ratable flow-through method of normalizing its investment tax credits under former § 46(f)(2). Taxpayer also adopted a normalization method of accounting for purposes of claiming accelerated depreciation for public utility property in accordance with former §§ 167(l) and 168(f), and with § 168(i)(9). Moreover, Taxpayer has normalized its EDFIT in accordance with § 203(e) of the Act and Rev. Proc. 88-12, 1988-1 C.B. 637.

In C, Bill became effective in State1. Bill initiated changes to the regulated electric utility market structure and permitted customer choice of electric generation providers. As a condition of seeking recovery of stranded costs, an electric utility company had to either divest its non-nuclear generation assets in a sale approved by A, or divest or attempt to divest its non-nuclear generation assets in a public auction approved by A. Further, Bill allows each electric utility company to divest its nuclear generation assets and requires each electric utility company that elects to divest its nuclear generation assets to submit a divestiture plan with A.

As a result of Bill, Taxpayer sold D megawatts of generating assets to an unrelated third party, consisting of E fossil fuel plants located in State1, and sold F megawatts of generating assets to a related company, consisting of hydroelectric generating assets located in State1 and State2. These sales resulted in a pre-tax book gain.

Further, Taxpayer sold its ownership interest in G nuclear generating units at H in State1. While this sale results in a pre-tax book gain, such gain is determined without taking into account the regulatory asset created by the prior writedown of the cost of these units to their estimated fair market value. In I, prior to the sale of the nuclear generating units, Taxpayer reclassified the nuclear plant cost in excess of its estimated fair market value from a plant account to a regulatory asset for nuclear stranded costs.

As a result, a pre-tax book loss from the sale of these G nuclear generating units is recorded in the regulatory asset for nuclear stranded costs. Because the pre-tax book loss in the regulatory asset exceeds the pre-tax book gain (determined without taking into account the regulatory asset), the sale of the G nuclear generating units resulted in a net pre-tax book loss.

All stranded costs related to Taxpayer's divestiture from the generation business will be recovered by way of a transition charge included with Taxpayer's transmission and distribution bills to ratepayers. The net after-tax book gain resulting from the sale of Taxpayer's generating assets will be used to reduce Taxpayer's stranded costs. The nuclear stranded costs were, in fact, fully recovered by the end of J.

RULINGS REQUESTED

Taxpayer requests the Internal Revenue Service to rule on six issues:

1. Taxpayer will not violate the investment tax credit normalization rules if Taxpayer increases the net gain from the sale of the fossil fuel and hydroelectric generating assets by the remaining unamortized ADITC balances associated with these assets at the date of sale and returns such ADITC to its remaining distribution customers over the period Taxpayer recovers stranded costs from such customers.

2. Taxpayer will not violate the depreciation normalization rules with respect to EDFIT if Taxpayer increases the net gain from the sale of the fossil fuel and hydroelectric generating assets by the remaining unamortized EDFIT balances associated with these assets at the date of sale and returns such EDFIT to its remaining distribution customers over the period Taxpayer recovers stranded costs from such customers.

3. Taxpayer will not violate the investment tax credit normalization rules if Taxpayer decreases the net loss from the sale of the H nuclear generating assets (taking into account the regulatory asset for nuclear stranded costs created by the writedown of the nuclear plant costs to estimated fair market value) by the remaining unamortized ADITC balances associated with these assets at the date of sale where such net loss is used to increase stranded costs that will be recovered from Taxpayer's remaining distribution customers.

4. Taxpayer will not violate the depreciation normalization rules with respect to EDFIT if Taxpayer decreases the net loss from the sale of the H nuclear generating assets (taking into account the regulatory asset for nuclear stranded costs created by the writedown of the nuclear plant costs to estimated fair market value) by the remaining unamortized EDFIT balances associated with these assets at the date of sale where such net loss increases stranded costs that will be recovered from Taxpayer's remaining distribution customers.

5. Taxpayer will not violate the investment tax credit normalization rules if Taxpayer decreases the net loss from the sale of all the generating assets (nuclear and non-nuclear) by the remaining unamortized ADITC balances associated with these assets at the date of sale where such net loss is used to increase stranded costs that will be recovered from Taxpayer's remaining distribution customers.

6. Taxpayer will not violate the depreciation normalization rules with respect to EDFIT if Taxpayer decreases the net loss from the sale of all the generating assets (nuclear and non-nuclear) by the remaining unamortized EDFIT balances associated with these assets at the date of sale where such net loss increases stranded costs that will be recovered from Taxpayer's remaining distribution customers.

LAW AND ANALYSIS

The first determination involves the proper normalization treatment by Taxpayer, an elector under former § 46(f)(2), of its ADITC relating to its nuclear and non-nuclear generating assets that were sold to third parties.

Former § 46(f) provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former § 46(f)(2)(A) provides that no investment tax credit is available 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 credit determined under former § 46(a) and allowable by § 38. Also, under former § 46(f)(2)(B), no investment tax credit is available 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 credit determined under former § 46(a) and allowable by § 38.

Former § 46(f)(6) provides that for purposes of determining ratable portions under former § 46(f)(2)(A), 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 § 1.46-6(g)(2) of the Income Tax Regulations, "ratable" for purposes of former § 46(f)(2) 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. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of reducing is ratable if the amount to reduce cost of service is

allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by § 1.46-6(g)(2) for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the ADITC is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of former § 46(f)(2) are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case, Taxpayer has sold the assets that generated the ADITC and, as a result, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its ratepayers or by decreasing the net loss from the sale of the H nuclear generating assets or sale of all the generating assets (nuclear and non-nuclear) by those ADITC amounts.

The second determination involves the proper normalization treatment by Taxpayer of its EDFIT relating to its nuclear and non-nuclear generating assets that were sold to third parties.

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

In order to use a normalization method of accounting, § 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 not shorter than, the method and period used to compute its depreciation expense for such purposes.

Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 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 § 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 § 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 § 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 § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) 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 § 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) 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) 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 taxable year in which the different methods of depreciation are used.

Section 1.167(l)-1(h)(2)(i) 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 taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period of depreciation used in determining the allowance for depreciation under § 167(a).

Section 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

Section 203(e)(1) of the Act provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than this reserve would be reduced under the average rate assumption method ("ARAM").

The term "excess tax reserve" is defined in § 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former § 167(l)(3)(G)(ii) or § 168(e)(3)(B)(ii) as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of § 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that § 203(e) of the Act does not modify the normalization requirements of former § 167(l) or of § 168(i).

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its federal income tax liability, § 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under § 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, § 203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

In the present case, Taxpayer has sold the aforementioned public utility property. Retirements of public utility property subject to the normalization requirements of § 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see § 1.167(l)-1(h)(2)(i) and Rev. Proc. 88-12, 1988-1 C.B. at 639). As a result of the sale, these reserves cease to exist. A violation of the depreciation normalization rules will occur if there is any return to ratepayers, after the sale date, of the

unamortized EDFIT attributable to accelerated depreciation on public utility property that is sold. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

CONCLUSIONS

Hence, in each of the six rulings requested by Taxpayer, there would be a normalization violation if the remaining unamortized ADITC and EDFIT balances (or a proportionate part thereof) existing at the date of sale are returned to ratepayers by amortizing those amounts over the period Taxpayer recovers stranded costs from its ratepayers or by decreasing the net loss from the sale of the H nuclear generating assets or sale of all the generating assets (nuclear and non-nuclear) by those amounts. Because Taxpayer has sold the assets that generated the ADITC, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its ratepayers or by decreasing the net loss from the sale of the H nuclear generating assets or sale of all the generating assets (nuclear and non-nuclear) by those ADITC amounts. Additionally, the unamortized EDFIT associated with the sold generating assets ceases to exist at the date of sale. Consequently, a violation of the depreciation normalization rules will occur if there is any return to ratepayers, after the sale date, of those unamortized EDFIT amounts attributable to accelerated depreciation on public utility property.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the Industry Director, Natural Resources and Construction (LM:NRC).

Sincerely,

Kathleen Reed

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

Enclosures (2)
6110 copy
copy for return