Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Refer Reply To:
CC:PSI:B06 – PLR-141255-01
Date:
May 10, 2006

Re: Request for Private Letter Ruling Regarding Normalization

Taxpayer	=
State	=
Commission A	=
Commission B	=
Plant	=
Buyer	=
<u>A</u>	=
<u>B</u>	=
<u>C</u>	
<u>D</u>	=
<u>E</u>	=
<u>F</u>	=

Dear

This letter responds to a letter dated July 6, 2001, submitted on behalf of Taxpayer for a determination as to the normalization requirements under former section 46(f)(2) of the Internal Revenue Code and section 203(e) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 (the “Act”), for the 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 a corporation that provides electric and natural gas service in State. Taxpayer is subject to the regulatory jurisdiction of Commission A with regard to its retail sales and certain conditions of service in State and to the regulatory jurisdiction of Commission B with regard to its wholesale and wheeling rates.

Prior to the transaction at issue in this letter, Taxpayer owned a A percent interest in the Plant. The Plant, located in State, has at all times since it was placed in service been used in the provision of regulated electric service and has been regulated on a rate-of-return basis. On B, Taxpayer filed an application with Commission A to sell its interest in Plant and related assets to Buyer. The application included requests for approval of the sale and authorization to amortize the net gain from the sale over a C year period beginning D. The application was approved by Commission A on E, and the sale was consummated on F.

Taxpayer's accumulated deferred federal income taxes ("ADFIT") were reversed as a result of the sale, and are not at issue in Taxpayer's request. Taxpayer has not reflected the reversal of the excess deferred federal income taxes ("EDFIT") with respect to the Plant as an increase to its computation of net gain (as an offset to income tax expense) on the sale of its interest in the Plant. In its order authorizing the sale of Taxpayer's interest in the Plant, Commission A required that Taxpayer request the approval of the Internal Revenue Service to include the EDFIT as an offset to income tax expense.

RULINGS REQUESTED

Taxpayer requests the Internal Revenue Service to rule that Taxpayer is permitted to pass through the EDFIT associated with the Plant as part of the net gain from the sale of these assets without violating the depreciation normalization rules set forth in former Code section 167(l), Code section 168, and section 203(e) of the 1986 Act.

LAW AND ANALYSIS

Section 168(f)(2) 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 not 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 for 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(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 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) 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 section 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 section 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 section 167 or section 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 section 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former section 167(l)(3)(G)(ii) or section 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 section 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 section 203(e) of the Act does not modify the normalization requirements of former section 167(l) or of section 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, section 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 section 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, section 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 section 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see section 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 the ruling requested by Taxpayer, there would be a normalization violation if the remaining unamortized EDFIT balance (or a proportionate part thereof) existing at the date of sale is returned to ratepayers. Because Taxpayer has sold the assets that generated the EDFIT, the unamortized EDFIT associated with the sold generating assets ceased 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.

Consequently, Taxpayer may not pass through the EDFIT associated with the Plant as part of the net gain from the sale of these assets without violating the depreciation normalization rules set forth in former Code section 167(l), Code section 168, and section 203(e) of the 1986 Act.

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,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

cc: