Internal Revenue Service

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LEGEND:

Taxpayer =

Intermediate =

Parent =

Company X =
State A =
State B =
State C =
State D =
State E =
State F =
Commission A =
Commission B =
Commission C =
Commission D =

Commission E =
Commission F =
Commission G =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
$X =
Year 6 =

Director =

Dear :

This letter responds to the request, dated November 18, 2008, of Taxpayer for rulings on whether the disallowance provisions of § 46(f)[1] and § 168(f)(2) of the Internal Revenue Code of 1986 shall be applied to the Taxpayer as a result of Taxpayer's accounting and regulatory treatment of its investment tax credits (ITC) and contributions in aid of construction (CIAC).

The representations set out in your letter follow.

Taxpayer is a vertically-integrated electric company incorporated in State A. Taxpayer serves retail customers in various states. Taxpayer is an indirect subsidiary of Intermediate and files a consolidated return with Parent. Taxpayer is regulated by Commissions A, B, C, D, E, F, and G (the Commissions) with respect to rates and other conditions of service. In each of the jurisdictions, Taxpayer's rates are determined using a cost of service basis that allow Taxpayer to earn a reasonable rate of return on "rate base." Rate base is determined generally by reference to the original cost of utility plant in service, net of accumulated depreciation and adjusted for deferred taxes and other items. The assets included in the rate base calculation are subject to the depreciation and Investment Tax Credit (ITC) normalization rules set forth in § 168(i)(9) and former §§ 167(l) and 46(f). This process of setting rates requires that Taxpayer compute its tax expense element of cost of service, including both current and deferred components, so that all incurred costs are included in the determination.

Taxpayer's rate base with respect to an asset is recovered over an asset's estimated useful life as determined by the Taxpayer and approved by the Commissions. Taxpayer periodically conducts depreciation studies to determine whether the estimated life of assets remain accurate. In general, the Taxpayer's depreciation studies have resulted in an increase of the estimated life of the assets being reviewed. When this happens, the Taxpayer requests that the relevant commission or commissions permit recovery of the remaining rate base with respect to that asset over the increased useful life. This method of determining depreciation expense for ratemaking purposes has been used by Taxpayer since Year 1. Taxpayer has conducted depreciation studies four times, with approved rates implemented based on those studies in Year 2, Year 3, Year 4, and Year 5.

[1] The relevant portions of § 46(f) were repealed by the Revenue Reconciliation Act of 1990, Pub. L. 101-508. However, under § 50(d)(2), those provisions still apply with respect to property on which a regulated utility claimed the investment tax credit.

Historically, Taxpayer has determined ratemaking depreciation expense by applying a composite annual percentage rate to original cost on a Federal Energy Regulatory Commission account group basis by either jurisdiction or by generating facility. The composite annual percentage rate is based on an estimate of average useful life and net salvage. For the Taxpayer net salvage, the estimated value of the asset upon retirement reduced by the estimated cost to retire, remove, and dispose of the asset, is negative in the aggregate. The use of net salvage (where negative) in the composite annual percentage rate increases that rate and, because the composite annual percentage rates are also used in the calculation of the ITC amortization, increases the ITC amortization.

Taxpayer has long amortized ITC using a normalization method of accounting. As a result of a merger between Taxpayer and Company X, portions of Taxpayer that were part of Taxpayer prior to the merger use the rules set forth in § 46(f)(1) to comply with normalization and those parts of Taxpayer that were part of Company X prior to the merger use the rules set forth in § 46(f)(2) to comply with normalization. The portions of Taxpayer that were part of Company X thus elected to amortize the ITC to income ratably over the life of the asset giving rise to the ITC rather than to reduce rate base by the unamortized ITC.

Taxpayer has discovered that, for certain property, when it extended the useful life of the asset following a depreciation study, it did not extend the period over which the ITC is amortized for those assets. This failure to extend the amortization period resulted, in some cases, in a more rapid amortization of ITC than would have occurred had the period for the ITC also been adjusted. In addition, the use of negative net salvage value with respect to certain asset groups resulted in a more rapid amortization of ITC than would have otherwise occurred. These errors occurred in the parts of Taxpayer using § 46(f)(2) to comply with normalization. Rates were approved by Commissions B, C, E, and G using the calculations submitted by Taxpayer. Each of these Commissions has affirmatively asserted hat they intended to require full normalization with respect to all transactions at all times. The total of the ITC erroneously amortized by Taxpayer as described above is $X for the time period since Year 6.

Taxpayer includes Contributions in Aid of Construction (CIAC) in taxable income as provided in § 118(b). Taxpayer does not charge its retail customers a 'tax gross-up' and has intended to provide full normalization of the deferred taxes associated with this tax basis difference for all of its jurisdictions. However, with respect to States B, E, and F, Taxpayer has not provided full normalization with respect to this item. Each of the Commissions B, E, and F have stated their intent to comply fully with normalization in all of their decisions.

With respect to each of the items described above, Taxpayer has independently discovered the error. Further, to the extent that any of the Commissions approved rates based in part on these erroneous items, the Commissions were not aware of the erroneous nature of the underlying calculations but accepted the Taxpayer's representations.

Law and Analysis

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) of the Code 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) of the Code 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) of the Code 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(1)-1(a)(1) of 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(1)-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 taxable year in which the different methods of depreciation are used.

Section 1.167(1)-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 may be reduced 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(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

In Notice 87-82, 1987-2 C.B. 389, the Service discussed normalization treatment of CIACs. It provides, in relevant part, as follows:

> For regulatory accounting purposes, utilities typically disregard the receipt of CIACs on their regulated books of account and do not include CIACs or CIAC property in income, cost of service, or rate base. This method of accounting (the "noninclusion method") is equivalent to including a CIAC in income in the year of receipt and depreciating the related CIAC property in its entirety in the same year. Accordingly, a utility using the noninclusion method of accounting for a CIAC will be treated for purposes of the normalization rules as if it computed its regulated tax expense by depreciating the related CIAC property in its entirety in the year in which the CIAC is received, the Internal Revenue Service believes that this treatment is consistent with the noninclusion method of accounting and is necessary in order to carry out the purposes of the normalization rules.
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> Under the normalization rules, a utility must make adjustments to a reserve to reflect the deferral of taxes resulting from the difference between the amount of depreciation used to determine the utility's Federal income tax liability and the amount of depreciation used to compute regulated tax expense. In the typical

case, part of the utility's tax expense is deferred (i.e., taxes are actually paid to the Federal government after they are taken into account under the regulatory accounting method) because property is depreciated more rapidly in determining Federal income tax liability than in computing regulated tax expense. If a utility uses the noninclusion method of accounting for CIACs, however, CIAC property is depreciated less rapidly in determining Federal income tax liability than in computing regulated tax expense, and taxes are paid before they are taken into account under the regulatory accounting method. This prepayment, or negative deferral, of tax is also subject to the normalization rules, and the utility must make adjustments to the reserve for deferred taxes to reflect the prepayment.

Under these adjustments, the amount of deferred taxes on the utility's regulated books of account is offset or decreased by the prepayment of tax resulting from the taxable receipt of the CIAC. Thus, if a taxpayer reduces rate base by the deferred taxes resulting from normalization, any prepayment to tax resulting from the normalization of CIACs will increase the rate base to which the utility's rate of return is applied. Similarly, if a taxpayer treats the deferred taxes resulting from normalization as "zero-cost" or "no-cost" capital for ratemaking purposes, any prepayment of taxes resulting from the normalization of CIACs will decrease the amount of zero-cost capital or no-cost capital for ratemaking purposes.

Further adjustments are made to the reserve for deferred taxes when the timing differences with respect to CIAC property reverse. This occurs as depreciation is taken into account in determining Federal income tax liability over the applicable recovery period prescribed under § 168. As the reversal occurs, previously paid taxes will be taken in account under the regulatory accounting method that will reduce, ultimately to zero, the amount of prepaid tax resulting from the normalization of the CIAC.

The Taxpayer has followed a “noninclusion method” in normalizing its CIACs.

In general, the ITC was introduced in 1962 and repealed for years after 1985 by the Tax Reform Act of 1986. Former section 46(f) and section 1.46-6 of the Income Tax regulations provide limitations on the use of tax credits by public utilities. Former section 46(f)(1) provides a general rule that disallows tax credits for “public utility property” if, for ratemaking purposes, such investment tax credit is used to reduce the taxpayer’s cost of service or to reduce the taxpayer’s rate base unless such base rate reduction is restored ratably, or faster, over the property’s useful life for ratemaking purposes.

Former section 46(f)(2) of the Code 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 section 38. Also, under former section 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 section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 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 section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code 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 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. A composite annual percentage rate determined by taking into account salvage value or other items shall be considered to be ratable in the case of a determination (whether or not final) issued before March 22, 1979, and any rate order (whether or not final) that is entered into before June 20, 1979, in response to a rate case filed before April 23, 1979. For this purpose, the term “rate order” does not include an order by a regulatory body that perfunctorily adopts rates as filed if such rates are suspended or subject to rebate.

Section 1.46-6(f)(4) provides that the ITC is disallowed for any section 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with section 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with section 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's § 46(f) property.

Section 1.46-6(f)(8)(1) provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2). For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1st Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

For the periods during which Taxpayer included negative net salvage in its calculation of asset life for ITC purposes as well as for those periods during which Taxpayer failed to extend the amortization period of the ITC to reflect the adjusted estimated useful life of the assets, the effect of these actions was to flow the ITC to ratepayers more rapidly than if calculated without the negative net salvage and if the amortization period had been adjusted. However, this was not the intent of either the Taxpayer or of any of the Commissions A, B, C, D, E, F, or G. In addition, the Taxpayer failed to fully normalize the depreciation associated with the tax basis difference for CIAC in three jurisdictions. This too, was unintentional. Further, Commissions B, E, and F did not intend to approve rates calculated in part on any item that had not been fully normalized. As discussed above, Congress intended that the harsh sanctions of disallowance of a public utility's use of accelerated depreciation and recapture of the tax benefits of the past use of such accelerated depreciation to be imposed only, it at all, after a regulatory body has required or insisted upon such treatment by a utility. Because the relevant Commissions at all times required that Taxpayer comply with the normalization tax rules and because the inadvertent errors described above were not specifically addressed by any of the Commissions, no disallowance or recapture is required in this case.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, orders concerning this matter finalized by any of the Commissions after the date of this ruling are not necessarily subject to the same analysis as those considered above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technican Reviewer, Branch 6
(Passthroughs & Special Industries)

cc: