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April 27, 2015

LEGEND:

Taxpayer =

State A =
State B =
Transferee =

Commission A =
Commission B =
Date X =
Director =

Dear :

This letter responds to the request, dated October 31, 2014, on behalf of Taxpayer for a ruling on the proper treatment, under the normalization provisions of the Internal Revenue Code, of Taxpayer's Accumulated Deferred Income Tax (ADIT) as a consequence of the transfer of certain property, the depreciation of which originally gave rise to the ADIT.

The representations set out in the request follow.

Taxpayer is a corporation incorporated under the laws of State A. It is the common parent of a group of companies, each of which is a limited liability company that is disregarded for federal tax purposes. Taxpayer, through these companies, conducts operations in many segments of the natural gas industry, including

distribution, in State A. Taxpayer's operations are subject to the regulatory jurisdiction of Commission A with respect to rates and conditions of service. The rates Taxpayer may charge for its services are established on a rate of return basis. We note that Taxpayer operates in other states in addition to State A and is subject to the regulatory jurisdiction of other public utility commissions but they are not discussed here inasmuch as the property transferred in the transaction discussed below is under the regulatory jurisdiction of Commission A.

Transferee is a corporation incorporated under the laws of State B. Through the ownership of the membership interests in several disregarded entities, Transferee provides natural gas storage and transmission services to customers in State A. The storage and transmission businesses are subject to the regulatory jurisdiction of Commission B with regard to its rates and conditions of service. The rates for Transferee's distribution, storage, and transmission services are established on a rate of return basis.

On Date X, Taxpayer and Transferee executed agreements providing for Taxpayer to transfer distribution assets to Transferee in exchange for certain storage and transmission assets (and cash). This exchange is represented to qualify as a "like kind exchange," the treatment of which is provided in section 1031 of the Internal Revenue Code. Taxpayer's distribution assets are its relinquished property and the storage and transmission assets received from Transferee are the replacement property. Under § 1031, both Taxpayer and Transferee recognized insignificant gain or loss on the exchange and both carried over the basis in their respective relinquished property to their replacement property. For regulatory purposes, Taxpayer will record the replacement property at the same regulatory book value as the relinquished property. Prior to the exchange, Taxpayer had recorded an ADIT balance to reflect the deferral of federal income taxes attributable to its claiming accelerated depreciation with respect to the relinquished property as required by the normalization provisions of the Internal Revenue Code. At issue here is the treatment of the ADIT balance recorded by Taxpayer with respect to the relinquished property.

Taxpayer requests that we rule as follows:

1. In the context of a § 1031 exchange, it would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 for Taxpayer to recognize for ratemaking purposes a depreciation-related ADIT balance attributable to its replacement property in excess of the depreciation-related ADIT balance attributable to its relinquished property.

2. If the answer to Ruling 1 is affirmative, Taxpayer's prospective treatment of the federal ADIT balance attributable to the replacement property as though it had been actually generated by those assets will be consistent with § 168(i)(9) and § 1.167(l)-1.

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(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 taxable 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 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 the present case, Taxpayer has transferred the relinquished property and received the replacement assets in exchange. The relinquished property has been disposed of by Taxpayer and removed from Taxpayer's regulatory books of account. The ADIT at issue was created by the deferral of federal taxes attributable to Taxpayer's claiming accelerated depreciation with respect to the relinquished property as required by § 1.167(l)-1(h)(2). The disposal of the relinquished property from Taxpayer's regulatory books of account are the functional equivalent of a retirement of the property (see generally §§ 1.167(a)-8(a) and 1.168(i)-8(b)(2)) and § 1.167(l)-1(h)(2) provides that the accumulated ADIT balance is adjusted to reflect such dispositions. Accordingly, Taxpayer's ADIT balance must be adjusted to reflect the disposition of the relinquished property. The required adjustment is the removal of the ADIT balance with respect to the relinquished property from Taxpayer's regulated books of account.

Accordingly, we find that in the context of a § 1031 exchange, it would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 for Taxpayer to recognize for ratemaking purposes a depreciation-related ADIT balance attributable to its replacement property in excess of the depreciation-related ADIT balance attributable to its relinquished property. Because the relinquished property has been disposed of, the amount of the depreciation-related ADIT balance originally created with respect to

the relinquished property is adjusted to reflect that disposition and such balance is not considered attributable to the replacement property.

In addition, we find that since such balance must be reduced to reflect the disposition of the relinquished property, Taxpayer's prospective treatment of the federal ADIT balance attributable to the replacement property as though it had been actually generated by those assets will not be consistent with § 168(i)(9) and § 1.167(l)-1.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above Specifically, we express no opinion regarding any consequences of the exchange described above, including whether such exchange satisfies the provisions of § 1031.

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
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: