Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.

Telephone Number:

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Date:
June 28, 2016

LEGEND:

Taxpayer	=
Parent	=
State	=
Commission	=
Application	=
Final Decision	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
a	=
X	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Director	=

Dear :

This letter responds to Parent's request, made on behalf of Taxpayer, dated February 22, 2016, for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is incorporated under the laws of State and is wholly owned by Parent.

Taxpayer is included in the consolidated federal income tax return of which Parent is the common parent and employs the accrual method of accounting on a calendar year basis.

Taxpayer is a regulated, investor-owned public utility primarily engaged in the business of supplying electricity in State. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to the terms and conditions of service and particularly as to the rates it can charge for the provision of service. Taxpayer's rates before Commission are established on a rate of return basis. In computing its income tax expense element of cost of service in rate proceedings before Commission, Taxpayer normalizes the federal tax benefits attributable to accelerated depreciation.

In rate proceedings before Commission, Taxpayer generally uses the most recently-completed calendar year as its test year and then projects data for the subsequent five years. The final three of the projected five years are the years in which the rates determined under that rate proceeding will be in effect. In its rate cases before Commission, Taxpayer flowed through as a reduction in the tax expense element of cost of service the tax benefit of any repair deductions, estimated for tax purposes in excess of the amount of repair expense for book purposes. In Taxpayer's Case for Year 3 (Prior Case), Taxpayer had projected its level of repair deductions for Year 3 through Year 5 using the percentage repair allowance election provided for by Treas. Reg. § 1.167(a)-11(d)(2), its then-current method of calculating repair deductions.

On Date 1, Taxpayer filed a Form 3115 with the Internal Revenue Service on which it elected to change to the "safe harbor" method of accounting for repairs related to its transmission and distribution assets provided for in Revenue Procedure 2011-43, 2011-2 C.B. 326, for its Year 2 tax year. As a result of this change, Taxpayer claimed additional repair deductions on its tax returns for Year 2 through Year 5 (in addition to the § 481(a) adjustment claimed on its Year 2 tax return). Consequently, the tax benefits of repair deductions Taxpayer actually claimed in those years exceeded the level of repair-related tax benefits considered in the establishment of rates for Year 3 through Year 5. Taxpayer reflected the incremental repair deductions on a "flow through" basis for regulatory purposes, thereby reducing its tax expense by the tax benefit of the incremental tax deductions in the years those deductions were claimed and recorded a regulatory asset representing the future recovery of deferred income taxes for these incremental tax deductions. These incremental reductions to tax expense were not incorporated into the rate setting process and resulted in increase to Taxpayer's net income in the years in which they were "recorded."

On Date 2, Taxpayer filed an Application for a Year 6 rate case with Commission (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, Year 3. It then projected data for Year 4 through Year 8. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to be effective for the a-year period beginning Date 3.

During its Case proceedings, X, a party to the proceeding, asserted that Taxpayer's failure to have incorporated into its Prior Case rate-setting the incremental benefits produced in Year 3 through Year 5 by its repair method change will result in a detriment to ratepayers in future years. X estimated the future detriment as being equal to (1) the forecasted incremental tax expense for which ratepayers would be charged when the repair timing differences flowed through in Year 3 through Year 5 reverse in the future and (2) the absence of the accumulated deferred federal income taxes (ADFIT) that would have existed had the repair accounting method election prescribed by Revenue Procedure 2011-43 not been made (the deducted repair costs would have been capitalized and depreciated for tax purposes, thereby producing incremental ADFIT).

On Date 4, in a Final Decision, the Administrative Law Judge (ALJ) stated that a rate base offset was necessary but it did not use the computational methodology proposed by X. The ALJ based the calculation of the offset on the "net present value of future excess costs to ratepayers resulting from Taxpayer's proposed ratemaking treatment for the repair deduction as compared to the ratemaking tax treatment assumption in place at the time of the applicable repairs." Taxpayer's ADFIT reserve account was not affected by the rate base offset.

In the Final Decision, the ALJ also stated that he intended to comply with the Normalization Rules and that if Taxpayer were to receive an IRS ruling contradicting the decision, then Taxpayer should comply with the IRS's interpretation of the applicable tax laws and seek an appropriate adjustment to its revenue requirement and/or rate base.

Ruling Requested

Taxpayer requests a ruling that the reduction of Taxpayer's rate base by the rate base offset described above will not be inconsistent with and therefore, will not violate the requirements of § 168(i)(9) and Treasury Regulations § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code 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.

Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of accounting if the reserve by which the rate base is reduced exceeds the amount of such reserve used in determining the taxpayer's expense in computing cost of service in such ratemaking.

In order to use a normalization method of accounting, § 168(i)(9)(A) requires that a 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.

Thus, the normalization provisions contained in § 168(f)(2) require that a taxpayer having public utility property that calculates its depreciation deduction under § 168 must maintain and adjust a reserve account reflecting the deferral of taxes resulting from the differences between the depreciation deduction under § 168 and the depreciation deduction used for its regulated tax expense. The rate base offset ordered in Final Decision was calculated based on the net present value of future excess costs to ratepayers resulting from Taxpayer's anticipated ratemaking treatment for the repair deduction as compared to the ratemaking tax treatment assumption in place at the time of the applicable repairs. No portion of the rate base offset was calculated based on any element of the depreciation deduction.

Conclusion

The reduction of Taxpayer's rate base by the rate base offset described above will not be inconsistent with and therefore, will not violate the normalization rules provided by § 168(i)(9) and Treasury Regulations § 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.

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 representatives. We are also sending a copy of this letter ruling to the Director.

Sincerely,

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

cc: