Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: Unrelated Taxpayer
Date of Communication: September 13, 2016

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-125020-16

Date:
February 07, 2017

In Re:

LEGEND:

Parent	=
Taxpayer	=
Commission	=
Commission Form	=
Commission Decision 1	=
Commission Decision 2	=
Customer	=
Court	=
State A	=
State B	=
State C	=
State D	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=

Date 18	=	
Date 19	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Director	=	

Dear :

This letter responds to the request, dated August 11, 2016, submitted by Parent on behalf of Taxpayer 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, a single member limited liability company, engaged in the transmission of electricity and operates a high voltage system in States A, B, C, and D that transmits electricity from generating stations to local distribution facilities connected to its system. Taxpayer is also an independent transmission utility subject to regulation by Commission with respect to terms and conditions of services, including the rates it may charge for its services.

Taxpayer transmission rates are set annually using a Commission-approved formula rate. The formula uses a cost-of-service model. On Date 1 of each year, Taxpayer estimates its revenue requirement for the following calendar year, the service year, based in part on the facilities in service at that time and those expected to be placed in service during that year. This estimate of Taxpayer's revenue requirement, a true-up from a given year (discussed below), and a Commission-approved rate of return are entered into the template for the formula to calculate the rates. The rates for that calendar year are determined under the Commission-approved formula and go into effect on Date 2 of the following calendar year with no additional action by Commission, although the rate is subject to legal challenge at the Commission.

The Commission-approved formula rate template contains a “true-up” mechanism under which the Taxpayer compares its actual revenue requirement to its actually-billed revenues for the service year. The actual net revenue requirement for a service year is determined after the end of the service year based on operating costs and capital cost actually incurred during the service year. The actual net revenue requirement for the service year and, accordingly, the true-up amount computed in the year following the service year are based largely on the amounts reported in the annual Commission Form for the service year. The billed revenues for such service year are based on the projected revenue requirements and rates estimated prior to the service year and the amount of network load on the transmission systems and transmission services provided by Taxpayer during the service year. If billed revenue is greater than the actual revenue requirement for the service year the over-collection is refunded in customer bills within two years of the service year; if billed revenue is less than the actual revenue requirement for the service year the under-collection is collected two years after the service year. For both under and over collections, a carrying charge equivalent to Commission's standard refund interest rate is imposed. The over- or under-collection typically results from differences between the projected revenue requirement used to establish the billing rate and actual revenue requirement or from differences between actual and projected monthly peak loads.

On Date 3, Taxpayer posted its projected revenue requirement for the Year 3 service year based on, among other estimates, plant additions for Year 3, book and tax depreciation for Year 3, current and deferred tax expense for Year 3 and the deferred tax reserve as of the end of Year 3. Taxpayer estimated its tax depreciation, deferred tax reserve and current and deferred tax expense based on its intention to elect out of the additional first year depreciation deduction on its Year 3 tax return.

On December 19, 2014, the Tax Increase Prevention Act of 2014 (P.L. 113-295) was enacted and amended § 168(k) to extend the 50 percent additional first year depreciation deduction on qualified property placed in service before January 1, 2015, and, for property described in § 168(k)(2)(B) or (C), placed in service before January 1, 2016. Parent paid estimated federal income taxes for Year 3, based on its intention to not deduct the additional first year depreciation on any of its qualified property placed in service during Year 3. On December 18, 2015, §§ 143(a)(1) and 143(b)(1) of the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) further amended § 168(k) to extend the 50 percent additional first year depreciation deduction on qualified property placed in service before January 1, 2016, and for property described in § 168(k)(2)(B) or (C), placed in service before January 1, 2017.

On Date 5, Customer submitted a formal challenge to Commission with respect to certain inputs of Taxpayer's formula rates. Specifically, Customer challenged the amounts of accumulated deferred federal income taxes (ADFIT) used to calculate charges for transmission services over Taxpayer's facilities and alleged that Taxpayer unreasonably and imprudently opted out of using the additional first year depreciation for calculation of its federal income tax expense, thereby understating the ADFIT amounts and unduly increasing the transmission charges that Customer must pay for transmission service, adversely affecting consumers served by Customer.

On Date 7, Parent made its Year 3 extension payment to the Service taking into account its first quarter Year 4 estimated tax payment. Because Parent had not yet determined that it would elect to not deduct the additional first year depreciation for Year 3 or Year 4, Parent did not reduce its Year 3 extension payment or its first quarter Year

4 estimated tax payment for any overpayment of its Year 3 estimated taxes. On Date 8, Taxpayer made an intercompany tax payment to Parent related to the Year 3 extension and the Year 4 first quarter estimate that reflected its intention to elect to not deduct the additional first year depreciation for Year 3 or Year 4. Because Taxpayer also had not yet determined that it would elect to not deduct additional first year depreciation for Year 3 or Year 4, Taxpayer did not reduce this intercompany tax payment for any overpayment of Year 3 estimated taxes.

On Date 7, Commission granted in part and denied in part the formal challenge filed on Date 5 by Customer, and found that Taxpayer had not demonstrated that its decision, through its corporate parent to opt out of using the additional first year depreciation for calculation of its federal income tax expense was prudent. Commission required Taxpayer to recalculate its transmission revenue requirements, effective Date 4, to simulate the taking of additional first year depreciation for eligible facilities in Year 3. However, Commission declined to require Taxpayer to simulate the taking of additional first year depreciation in the calculation of its transmission revenue requirement for years prior to Year 3 for which Taxpayer elected not to deduct the additional first year depreciation because imputing additional first year depreciation in the calculation of Taxpayer's revenue requirements for such years "may pose a risk of a normalization violation." For the Year 3 service period, Commission Decision 1 stated "[t]o the extent that [Taxpayer] believes that our requiring it to simulate the taking of bonus depreciation would create the possibility of a normalization violation, [Parent] (and therefore [Taxpayer] has the ability to avoid this violation by filing a tax return for [Year 3]) without opting out of bonus depreciation."

On Date 9, after analysis of Commission Decision 1, Taxpayer's management determined that it would deduct the additional first year depreciation on its Year 3 and Year 4 tax returns.

On Date 10, Taxpayer requested a rehearing at Commission, arguing that Commission has no authority to negate the statutory right of a taxpayer to opt out of deducting the additional first year depreciation by declaring such an election imprudent and that Commission lacks the authority to require Taxpayer to simulate the taking of the additional first year depreciation in setting its rates. Taxpayer also requested Commission should not apply the ratemaking effects of the Year 4 decision to deduct the additional first year depreciation retroactively to Date 4, as provided in Commission Decision 1. On Date 10, Taxpayer filed its Commission Form for the Year 3 service year with its ADFIT computed in a manner consistent with its intention as of Date 6, to not deduct the additional first year depreciation on its Year 3 tax return.

Taxpayer did not have an ability to reduce its first three quarterly Year 4 estimated tax payments for the anticipated overpayment of Year 3 estimated taxes because Parent and Taxpayer expect to incur net operating losses (NOLs) in Year 4 and, thus, Parent did not make estimated tax payments and Taxpayer did not make tax-sharing payments to Parent for these quarters.

On Date 11, Taxpayer posted its Year 3 formula rate true-up computing an actual Year 3 revenue requirement for purposes of determining the Year 3 true-up to be refunded in Year 5 with interest accruing beginning in Year 3. The computation of deferred taxes in the actual Year 3 revenue requirement, as provided in Commission Decision 1, reflected Taxpayer's decision in Year 4 to deduct the additional first year depreciation for Year 3. Because this Year 4 decision was not reflected in Taxpayer's Commission Form for Year 3, adjustments were required to the reported ADFIT balances as of Date 6, in order to reflect the deduction of the additional first year depreciation for Year 3, pursuant to Commission Decision 1.

On Date 13, Parent filed its Year 3 consolidated federal income tax return. Parent reported a consolidated NOL and Taxpayer deducted the additional first year depreciation resulting in a NOL on a stand-alone basis. On Date 16, Parent received a refund from the Service of its Year 3 estimated federal income taxes paid and on Date 18, Parent made an inter-company tax-sharing payment to Taxpayer related to the refund of Year 3 estimated federal income taxes.

On Date 14, Parent filed Forms 1139 (Corporation Application for Tentative Refund) to carry back its Year 3 NOL to its Year 1 and Year 2 tax years. On Date 17, Parent received the refund from the Internal Revenue Service resulting from the carryback of its Year 3 consolidated NOL to Year 1 and on Date 18, Parent made an inter-company tax-sharing payment to Taxpayer related to the refund of Year 1 NOL carryback.

On Date 12, Commission issued Commission Decision 2 denying rehearing and reconsideration that was requested by Taxpayer on Date 10. On Date 15, Taxpayer filed a petition to appeal Commission Decision 1 and Commission Decision 2 related to the Year 3 actual revenue requirement and true-up adjustment with the Court (the Appeal). The Appeal keeps the rate proceeding open procedurally and allows Commission to consider amending Commission Decision 1 and Commission Decision 2 and setting rates in a manner that complies with the normalization requirements, in the event the Service finds that the ratemaking prescribed by Commission Decision 1 and Commission Decision 2 would violate the normalization requirements if finalized and implemented. Taxpayer and Customer subsequently filed various motions and responses with the Court. On Date 19, the Court granted Taxpayer's motion to hold the appeals in abeyance.

Commission at all times has required that all public utilities under its jurisdiction use normalized methods of accounting.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above whereby the Commission orders a change in a management decision to elect not to deduct the additional first year depreciation for Year 3 and management decides, in Year 4, to deduct the additional first year depreciation on its Year 3 tax return, reflecting a reserve for accumulated federal income taxes (ADFIT) for the book/tax difference attributable to the additional first year depreciation deducted in Year 3 in the calculation of its Year 3 actual revenue requirement would violate the normalization requirements because that depreciation deduction did not result in the deferral of any taxes by the end of Year 3.

2. Whether, under the circumstances described above, adjusting Taxpayer's reserve for ADFIT for purposes of the true-up of Year 3, effective for rates in Year 5 and in its regulatory books of account to reflect additional first year depreciation deductions taken in its tax return for Year 3 would comply with the normalization requirements.

3. If, under the circumstances described above, the Service considers Taxpayer's ratemaking practice to violate the normalization requirements, when would Taxpayer's loss of the right to accelerated tax depreciation due to such violation begin.

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 168(i)(9)(C) provides that in the case of any public utility property to which § 168 does not apply by reason of § 168(f)(2), the allowance for depreciation under § 167(a) shall be an amount computed using the method and period referred to in § 168(i)(9)(A)(i).

Section 168(i)(10) provides, in part, that the term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility Commission or other similar body of any State or political subdivision thereof.

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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer’s reasonable allowance under § 167(a) results in a net operating loss carryover (NOLC) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under

§ 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

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, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) 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. That section also notes 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 § 1.167(l)-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 § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

As described above, there are two ratemakings with respect to Taxpayer in the years under consideration. In the first, Taxpayer estimates its revenue requirement and in the second, there is a true-up which compares its actual revenue requirement to its actually-billed revenues for the service year. Whether, under these facts, the true-up ratemaking violates the normalization rules is the matter at issue here. Taxpayer based its estimates for the first ratemaking on its intention to elect to not claim the additional first year depreciation on its Year 3 tax return. However, Taxpayer’s management decided to claim the additional first year depreciation following Commission’s order to do so. On Taxpayer’s Year 3 tax return, it claimed the additional first year depreciation. Thus, the rates that were determined (in part) by the true-up and went into effect in Year 5, were based on the actual taxes claimed by the Taxpayer on its Year 3 return and not on the estimates that were used by Taxpayer to determine those rates in effect during Year 3. Thus, Taxpayer’s ADFIT was also adjusted for purposes of the true-up appropriately by reference to the Taxpayer’s actual Year 3 tax liability and the amount of Federal taxes deferred by reason of the use of the additional first year depreciation.

Taxpayer has argued that there is a violation of the consistency rule set forth in § 168(i)(9)(B). We view the initial ratemaking and the true-up as distinct ratemakings. There is no requirement of consistency between separate ratemakings, even where one (here the true-up) seeks to correct the outcome of the other. Taxpayer changed its decision regarding the additional first year depreciation (under an order by Commission) from its initial intent to elect out of the additional first year depreciation deduction under which it made the estimates in the first ratemaking to its decision to claim the additional first year depreciation on its Year 3 return under which the true-up was calculated. In fact, Taxpayer chose to take the additional first year depreciation and actually took the additional first year depreciation on its Year 3 tax return. There was no simulation in the true-up but rather a reflection of the choice by Taxpayer to claim the additional first year depreciation. Thus, there is no consistency rule violation in the calculation of the true-up described above. Further, we do not believe that the decision by Commission results in Taxpayer’s tax reserve exceeding the maximum allowable amount as described in § 1.167(l)-1(h) for the true-up.

Regarding the third issue, because in the circumstances described above, Taxpayer’s true-up ratemaking complies with the normalization requirements, the issue of the timing of the tax effects of a normalization violation is moot.

Accordingly, we rule as follows:

1. Under the circumstances described above whereby the Commission orders a change in a management decision to elect not to deduct the additional first year depreciation for Year 3 and management decides, in Year 4, to deduct the additional first year depreciation on its Year 3 tax return, reflecting a reserve for accumulated federal income taxes (ADFIT) for the book/tax difference attributable to the additional first year depreciation deducted in Year 3 in the calculation of its Year 3 actual revenue requirement would not violate the normalization requirements because that depreciation deduction did not result in the deferral of any taxes by the end of Year 3.

2. Under the circumstances described above, adjusting Taxpayer's reserve for ADFIT for purposes of the true-up of Year 3, effective for rates effective in Year 5 and in its regulatory books of account to reflect additional first year depreciation deductions taken in its tax return for Year 3 would comply with the normalization requirements.

3. This issue is moot as discussed above.

While the taxpayer also requested a change in method of accounting ruling for the change in computing depreciation as a result of a normalization violation, this issue is moot because we have concluded that there is not any normalization violation.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In addition, we express no opinion regarding whether the Commission has the authority, as expressed in Commission Decision 1 and Commission Decision 2, to order Taxpayer to claim the additional first year depreciation on its tax return, rather than to elect out of the additional first year depreciation deduction. Further, no opinion is expressed or implied on whether any of the property for which Taxpayer claimed the additional first year depreciation is qualified property as defined in § 168(k).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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,

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)