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Date:
March 14, 2018

In Re:

LEGEND

Taxpayer A =

Taxpayer B =

Partnership =

Taxpayer A, LLC =

Taxpayer B, LLC =

State A =

State B =

Regulator =

Date 1 =

a =

b =

c =

d =

e =

Taxpayer A Liability =

Taxpayer B Liability =

Dear :

This letter responds to a request for a private letter ruling dated September 22, 2017, and subsequent correspondence, submitted on behalf of Taxpayer A by your authorized representatives. Taxpayer A requested a ruling regarding the application of the normalization rules under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations to an exchange of like kind properties between Taxpayer A and Taxpayer B. The relevant facts as represented in your submissions are set forth below.

FACTS

Taxpayer A is a State B limited liability company, which is classified as a partnership for federal income tax purposes. Taxpayer A owns and operates a regulated electricity transmission and distribution system in State A. Taxpayer A provides distribution services to retail electric providers that sell electricity to consumers. Taxpayer A also provides transmission services to other electricity distribution companies, cooperatives, municipalities, and retail energy providers. Taxpayer A's operations are subject to the regulatory jurisdiction of the Regulator for rates and conditions of service. The rates for the distribution and transmission services are established under traditional ratemaking on a rate base/rate of return basis.

Taxpayer B is a State A limited liability company, which is classified as a partnership for federal income tax purposes. Taxpayer B owns regulated electricity transmission and distribution facilities throughout State A. Taxpayer B leases these facilities to Partnership, a State A limited partnership, which is classified as a partnership for federal income tax purposes. Partnership operates the electricity transmission and distribution facilities and provides both distribution services to retail electric providers that sell electricity to consumers and transmission services to other

electricity distribution companies, cooperatives, municipalities, and retail energy providers. The operation of the electricity transmission and distribution facilities is subject to the regulatory jurisdiction of the Regulator for rates and conditions of service. The rates for the distribution and transmission services are established under traditional ratemaking on a rate base/rate of return basis.

On Date 1, Taxpayer A, Taxpayer B, and Partnership entered into an Agreement and Plan of Merger, pursuant to which Taxpayer A will transfer certain of its electricity transmission facilities to Taxpayer B, and Taxpayer B will transfer substantially all of its electricity distribution facilities and certain of its electricity transmission facilities to Taxpayer A ("Merger Agreement"). This transaction will allow Taxpayer A to expand its existing distribution network into a growing service area it had not previously served, and add additional retail customers. This transaction will provide Taxpayer B with additional transmission assets to meet the infrastructure needs for safe, reliable, and affordable electric power of a growing State A economy.

Pursuant to the Merger Agreement, the following transactions will occur after the taxpayers receive the necessary approvals:

1) Taxpayer A will transfer certain of its electricity transmission facilities ("Taxpayer A Assets") to a newly-formed limited liability company (Taxpayer A, LLC). Taxpayer A, LLC will be wholly-owned by, and treated as a disregarded entity as to, Taxpayer A. Taxpayer A represents that as a result, Taxpayer A will be deemed to continue to own the Taxpayer A Assets for federal income tax purposes.

2) Taxpayer B will transfer assets comprising substantially all of its electricity distribution facilities and certain of its electricity transmission facilities ("Taxpayer B Assets") to a newly-formed limited liability company, Taxpayer B, LLC. Taxpayer B, LLC will be wholly-owned by, and treated as a disregarded entity as to, Taxpayer B. Taxpayer A represents that as a result, Taxpayer B will be deemed to continue to own the Taxpayer B Assets for federal income tax purposes.

3) Taxpayer A, LLC will merge with and into Taxpayer B, with Taxpayer B as the surviving entity. As a result, Taxpayer B will become the direct owner of the Taxpayer A Assets. Taxpayer A represents that for federal income tax purposes, because Taxpayer A, LLC is disregarded, Taxpayer A will be deemed to transfer the Taxpayer A Assets to Taxpayer B.

4) Substantially simultaneously with, and as consideration for, the transfer of the Taxpayer A Assets by Taxpayer A to Taxpayer B, Taxpayer B, LLC will merge with and into Taxpayer A, with Taxpayer A as the surviving entity. Taxpayer A will also pay cash to Taxpayer B for a small portion of the Taxpayer B Assets. As a result, Taxpayer A will become the direct owner of the Taxpayer B Assets. Taxpayer A represents that for

federal income tax purposes, because Taxpayer B, LLC is disregarded, Taxpayer B will be deemed to transfer the Taxpayer B Assets to Taxpayer A.

The third and fourth transactions are expected to be treated for tax purposes as a like kind exchange under § 1031 between Taxpayer A and Taxpayer B of the Taxpayer B Assets for the Taxpayer A Assets (and cash). Substantially all of this exchange is expected to be treated as an exchange of properties that are of "like kind" within the meaning of § 1031 and, thus, qualify for tax deferred treatment. However, Taxpayer B, and possibly Taxpayer A, are expected to have some amount of "exchange group deficiencies" or "exchange group surpluses" within the meaning of § 1.1031(j)-1(b)(4). Therefore, the taxpayers may recognize some amount of taxable gain in the like kind exchange. Taxpayer A and Taxpayer B will take a substituted tax basis in the assets acquired by each of them, adjusted as specified in § 1.1031(j)-1(c) for exchange group deficiencies and surpluses and taxable gain recognized.

For regulatory purposes, Taxpayer A will record the Taxpayer B Assets it will receive at the same regulatory net book value at which those assets had been recorded by Taxpayer B immediately prior to the like kind exchange. Similarly, Taxpayer B will record the Taxpayer A Assets it will receive at the same regulatory net book value at which those assets had been recorded by Taxpayer A immediately prior to the like kind exchange. The regulatory net book value of the Taxpayer B Assets is expected to approximately equal the regulatory net book value of the Taxpayer A Assets, plus the amount of cash paid by Taxpayer A to Taxpayer B in the like kind exchange.

For federal income tax purposes, Taxpayer A and Taxpayer B claimed accelerated depreciation (including, in certain cases, bonus depreciation) on the assets they owned. The Taxpayer A Assets include electricity transmission systems. The Taxpayer B Assets include electricity distribution systems and electricity transmission systems.

Prior to the like kind exchange, each taxpayer recorded an accumulated deferred federal income tax ("ADFIT") reserve to reflect the deferral of federal income taxes attributable to its claiming accelerated depreciation and for other temporary differences for its public utility assets. Immediately prior to the consummation of the like kind exchange, it is projected that Taxpayer A will have an ADFIT reserve balance attributable to the Taxpayer A Assets of approximately $a, approximately $b of which will be attributable to accelerated depreciation. Further, immediately prior to the consummation of the like kind exchange, Taxpayer B is projected to have an ADFIT reserve balance attributable to the Taxpayer B Assets of approximately $c, substantially all of which will be attributable to accelerated depreciation. Taxpayer A and Taxpayer B propose to record the following entries to their regulated books of account to reflect the like kind exchange.

Taxpayer A will remove from its regulated books of account the entire approximately $a of ADFIT reserve balance associated with the Taxpayer A Assets it is relinquishing. Similarly, Taxpayer B will remove the entire approximately $c of ADFIT reserve balance associated with the Taxpayer B Assets it is relinquishing. Taxpayer A will increase a non-operating income account in the amount of the ADFIT reserve so removed. Similarly, Taxpayer B will increase a non-operating income account in the amount of the ADFIT reserve balance it removed.

Taxpayer A will record the Taxpayer B Assets it is acquiring as an asset on its regulated books of account in an amount equal to Taxpayer B's regulatory net book value in the Taxpayer B Assets immediately prior to the like kind exchange. Similarly, Taxpayer B will record the Taxpayer A Assets it is acquiring as an asset on its regulated books of account in an amount equal to Taxpayer A's regulatory net book value in the Taxpayer A Assets immediately prior to the like kind exchange. As a result, Taxpayer A's initial net book basis in the Taxpayer B Assets it is acquiring is projected to be approximately $d, and Taxpayer B's initial net book basis in the Taxpayer A Assets it is acquiring is projected to be approximately $e.

Taxpayer A will book Taxpayer A Liability. Similarly, Taxpayer B will book Taxpayer B Liability. When Taxpayer A and Taxpayer B recover the book carrying value of the replacement property in rates, they will have to pay the Taxpayer A Liability and Taxpayer B Liability, respectively, to the government. Taxpayer A and Taxpayer B will have removed the ADFIT associated with the relinquished property from their regulated books of account, and will not record any of the replacement properties' pre-transactional ADFIT.

Taxpayer A represents that its accounting entries are in accordance with GAAP applicable to rate regulated enterprises. Based on discussions with Regulator staff and others, Taxpayer A has concluded that it will not collect the Taxpayer A Liability from customers. Thus, Taxpayer A does not anticipate establishing a regulatory asset. As a result, Taxpayer A's post-like kind exchange rate base computation will be reduced by its Taxpayer A Liability balance in addition to any additional ADFIT balances that are created after the transaction.

RULING REQUESTED

Subsequent to the like kind exchange, it will be consistent with the requirements of § 168(i)(9) and § 1.167(1)-1 for Taxpayer A to recognize the Taxpayer A Liability balance for ratemaking purposes and record such balance on its regulated books of account.

LAW AND ANALYSIS

Section 168(f)(2) 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.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires 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 for 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), then 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 the definition 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.

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 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).

Taxpayer A has transferred the Taxpayer A Assets and received replacement assets in exchange. Taxpayer A has disposed of Taxpayer A Assets, and those assets have been removed from Taxpayer A's regulatory books of account. Taxpayer A's ADFIT was created due to the deferral of federal taxes attributable to Taxpayer A's claiming accelerated depreciation and other temporary differences with respect to the relinquished property as required by § 1.167(l)-1(h)(2). The disposal of the relinquished property from Taxpayer A's regulatory books of account is the functional equivalent of a retirement of the property (see generally §§ 1.167(a)-8(a) and 1.168(i)-8(b)(2)). Section 1.167(l)-1(h)(2) provides that the accumulated ADFIT balance is adjusted to reflect such dispositions. The required adjustment is the removal of the ADFIT balance with respect to the relinquished property from Taxpayer A's regulated books of account.

In accordance with this requirement, Taxpayer A will remove from its regulated books of account the entire approximately $a of ADFIT reserve balance associated with the Taxpayer A Assets it is relinquishing. Taxpayer A will not record on the utility's regulated books of account any of the replacement properties' pre-transactional ADFIT

In this case, we are satisfied that the Taxpayer A Liability is unrelated to the relinquished properties' ADFIT, and thus, its regulatory treatment is beyond the scope of the normalization rules. Therefore, we conclude that subsequent to the like kind exchange, it will be consistent with the requirements of § 168(i)(9) and § 1.167(1)-1 for Taxpayer A to recognize the Taxpayer A Liability balance for ratemaking purposes and record such balance on its regulated books of account.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations. 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 requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

David A. Selig
Senior Counsel, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)