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Date:
May 01, 2022

LEGEND:

Parent =

Taxpayer =

State A =

Commission 1 =

Commission 2 =

Year A =

Period A =

Dear

This letter responds to a request for a private letter ruling dated October 8, 2021, and submitted on behalf of Taxpayer regarding § 168(i)(9) of the Internal Revenue Code (Code), prior § 167(l) of the Code, and § 1.167(l)-1 of the Income Tax Regulations, and Section 13001(d) of Pub. L. 115-97 (131 Stat 2054) (“ the TCJA”) (together, the “Normalization Rules”), as applied to the calculation of the method used by Commission 2 in a recent rate proceeding to reflect federal income tax expense reductions for

Taxpayer for excess deferred federal income taxes created by the corporate tax rate reduction included in the TCJA.

FACTS:

Parent is a State A corporation. Parent is the common parent of a consolidated group that includes Taxpayer (a subsidiary of Parent). Taxpayer is also a State A corporation. Taxpayer's common stock is wholly owned by Parent through a different subsidiary. The consolidated group, including Parent and Taxpayer, files its return on a calendar year basis. Taxpayer is engaged is the business of supplying and delivering natural gas to customers.

For rate setting purposes, Taxpayer is under the jurisdiction of Commission 1 and Commission 2. Both regulators set the rates that Taxpayer charges its customers on a cost-of-service rate of return basis – in which the regulators allow the Taxpayer to charge an amount that will cover its costs of providing the energy and yield the Taxpayer a predetermined rate of return on invested capital.

Both Commission 1 and Commission 2 treat accumulated deferred federal income tax liabilities ("ADFIT") and excess deferred federal income tax liabilities ("EDFIT") as a reduction to rate base in setting the allowed return for the utilities that they regulate. Taxpayer has claimed accelerated depreciation on its public utility property to the full extent those deductions have been available. Taxpayer has normalized its federal income taxes deferred as a result of it claiming these deductions in accordance with the Normalization Rules.

Commission 1 has established the Uniform Systems of Accounts ("USOAs"), prescribing the accounting rules which are used by most electric and gas utilities under its jurisdiction. Taxpayer employs the USOAs. The USOAs contain several definitions relevant to Taxpayer's request. Specifically, the USOAs define:

cost of removal ("COR") as the cost of demolishing, dismantling, tearing down or otherwise removing [electric/gas] plant, including the cost of transportation and handling incidental thereto.

"salvage value" as the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale.

"net salvage value" as the salvage of property retired less the cost of removal.

"service value" as the difference between original cost and net salvage value of [electric/gas] plant.

“service life” as the time between the date [electric/gas] plant is includible in [electric/gas] plant in service, or [electric/gas] plant leased to others, and the date of its retirement.

and “depreciation” as the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of [electric/gas] plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance.

Therefore, for the purposes of regulatory reporting, the net positive value or net cost of disposing an asset at the end of its life is incorporated into the annual depreciation charge. Salvage Value and COR are, therefore, components of establishing the applicable depreciation rate. The combined rate, including depreciation, salvage, and COR, is considered the Composite Rate that is approved by Commission 2.

Although the Composite Rate is approved by Commission 2 and includes each of these items, COR and salvage rates are tracked separately from accumulated depreciation in Taxpayer’s property-related deferred tax records. Taxpayer distinguishes between COR book/tax differences and depreciation method/life differences in their records even though both are included in Taxpayer’s depreciation book rates and expense. Taxpayer’s property-related software system tracks the reversals of these differences separately.

In order to fund its future COR, Taxpayer estimates its future COR and then spreads the estimated cost ratably over the life of the asset through adding the COR to the annual depreciation charge used by Commission 2 to calculate the allowable rate for Taxpayer to charge its customers. If the COR is greater than the salvage value of the public utility property, then the Taxpayer’s property will have a negative net salvage value – which will increase the depreciation rate (i.e. total accumulated depreciation will be greater than the value of asset). Alternately, if the net salvage value is positive it too will be reflected in Taxpayer’s depreciation rate. Depreciation expense based on the deprecation rate will then be utilized by Commission 2 in computing the allowable rates for Taxpayer to charge its customers. In most cases the COR is more than the salvage value and thus net salvage value is negative, increasing the Taxpayer's accumulated depreciation account. When the COR is actually incurred, the amount expended is charged to that same accumulated depreciation account, reducing the balance.

For tax purposes, COR is deductible only when actually incurred. Taxpayer, therefore, reports its customer collections that fund the COR reserve as taxable income over the operating life of an asset, claiming an offsetting tax deduction only at the end of the life of that asset when the asset is removed. Since COR is normalized in setting rates, customers are provided a tax benefit as they fund the COR reserve – prior to the time Taxpayer actually claims that benefit on its consolidated tax return.

The tax effect of COR funding as described creates a deferred tax asset (“DTA”). This represents the future benefit to be derived from the eventual COR tax deduction. The COR-related DTA is included in Taxpayer’s overall plant-related ADFIT accounts that reduce Taxpayer’s ADFIT balance.

In anticipation of complying with the TCJA excess deferred tax Normalization Rules and the subsequent return of the TCJA Section 13001(d) excess tax reserve (“ETR”) to customers, Taxpayer used its historical plant-related records in its regulatory books of account to separately compute both (1) its DTA related to COR and (2) its deferred tax liability (DTL) related to method/life differences and the associated EDFIT to be returned to customers, which included gross salvage value.

Taxpayer’s Recent Commission 2 Proceeding:

In Year A Taxpayer filed an application with Commission 2 to set its rates for Period A. Upon the enactment of the TCJA, Taxpayer updated its filing with Commission 2 to reflect the impact of the lowered corporate tax rate. Among the impacts considered by Commission 2 was the proper computation of the Average Rate Assumption Method (ARAM) used to determine the timing of the return of the EDFIT to ratepayers. Specifically, when computing ARAM (as per TCJA Section 13001(d)(3)(B)), whether the COR should be included or not. Ultimately, Commission 2 and Taxpayer did not reach an agreement on the inclusion of COR into the ARAM and the resulting disagreements relating to the COR-related EDFIT.

In summary, Commission 2’s proposed method of computing the return of EDFIT to customers under ARAM included the accrual for COR, resulting in a larger amount of book depreciation in all years (and an earlier return of EDFITR to customers) than under the computational method proposed by Taxpayer. (Taxpayer’s proposed method did not include COR in the ARAM calculation.) Commission 2 adopted its method of computing the return of EDFIT in its Period A decision. Despite the disagreement, Commission 2 emphasized that it intended for Taxpayer to comply with the Normalization Rules at all times and found it prudent and reasonable to allow Taxpayer to seek recovery in the event the Internal Revenue Service issued a ruling or other guidance clarifying that COR should be excluded from ARAM calculations in these circumstances. Commission 2 recommended that Taxpayer seek a private letter ruling.

RULINGS REQUESTED:

1) Whether, under the circumstances described above, Commission 2’s method of including book COR in the calculation of ARAM for the return of the EDFIT to ratepayers is inconsistent with the Normalization Rules?

2) Whether, under the circumstances described above, the method proposed by Taxpayer excluding book COR from the ARAM calculation for return of the EDFIT to the ratepayers is consistent with the Normalization Rules?

3) Whether, under the circumstances described above, if the Service rules that the method proposed by Commission 2 is inconsistent with the Normalization Rules, Taxpayer's use of the method proposed by Commission 2 as provided in Commission 2's Period A decision, will not be a violation of the Normalization Rules, provided Commission 2 (i) approves the method proposed by Taxpayer (or otherwise required by the Service) and (ii) allows Taxpayer to recover any difference in the rates charged to customers under Commission 2's proposed method and Taxpayer's method, as provided in Commission 2's Period A decision?

LAW AND ANALYSIS:

Section 168(f)(2) of the Internal Revenue 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.

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.

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). Treas. Reg. § 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertains 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 13001(a) of the TCJA reduced the corporate tax rate from 35 percent to 21 percent for taxable years beginning after December 31, 2017. TCJA Section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the ETR[1] more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method (ARAM).

TCJA Section 13001(d)(3)(A) provides that ''excess tax reserve'' means the excess of reserve for deferred taxes (as described in § 168(i)(9)(A)(ii) as of the day before the corporate rate reductions provided in the amendments made by TCJA Section 13001(a) take effect, over the amount which would be the balance in such reserve, if the amount of such reserve were determined by assuming that the corporate tax rate reductions provided in the TCJA were in effect for all prior periods.

TCJA Section 13001(d)(3)(B) defines ARAM as the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such a method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying – the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by the amount of the timing differences which reverse during such period.

Rev. Proc. 2020-39, Section 4.01 provides that under Section 13001(d)(1) of the TCJA, taxpayers must use ARAM to calculate the reversal of their ETR, if the taxpayer's regulatory books are based upon the vintage account data necessary to use ARAM. However, if the taxpayer's regulatory books are not based upon the vintage account data that is necessary for the ARAM, use of the ARAM is not required. Rev. Proc. 2020-39, Section 4.02 provides that the determination of whether a taxpayer's regulatory books contain sufficient vintage account data necessary to use the ARAM is determined based on all the facts and circumstances. Rev. Proc. 2020-39, Section 5 states that the TCJA ETR normalization requirements are part of the overall pre-existing deferred tax Normalization Rules and that the revenue procedure is intended to be consistent with those rules.

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[1] ETR is used in section 13001 to refer to that portion of the reserve for deferred taxes described in § 168(i)(9)(A)(II) that is determined by the decrease in the corporate tax rate by the TCJA. It is sometimes referred to herein as EDFIT.

For the COR-related amounts at issue in this request, the amounts are not protected by the Normalization Rules. Generally, § 168(i)(9)(A) does not refer to COR, which is deductible under § 162. Moreover, there is no acceleration of taxes for COR that inures to the benefit of the utility company initially but must be reflected in a reserve and returned pro-rata to ratepayers, but rather, a deferral of the payment of those taxes. While COR may be a component of the calculation of the amount treated as book depreciation, it is a deduction under § 162 and not, like actual accelerated tax depreciation, under § 168. While method and life differences closely related to depreciation are created and reversed solely through depreciation, such is not the case with COR. While the COR timing differences may often originate as a component of book depreciation, it reverses through the incurred COR expenditure.

The ETR created by the TCJA is the excess of the reserve for deferred taxes under § 168(i)(9)(A)(ii), as of the date before the corporate rate reductions under TCJA take effect, over the amount the reserve balance would be if the rate reductions had been in effect for all prior periods. The ETR is reduced over the remaining lives of the property which gave rise to such reserve for deferred taxes based on the reversal of the underlying depreciation method and life differences subject to the Normalization Rules of Code Section 168(i)(9)(A)(ii). Thus, because COR is not subject to normalization, as concluded above, COR related amounts are not used in the computation of the ETR.

Because of their similarity, we address requests 1 and 2 together. As discussed previously, ARAM is the required method for the reduction/reversal of the ETR. Because COR is not included in the ETR, COR should not be included in the ARAM calculations to return the ETR to ratepayers under the Normalization Rules.

The third Issue requires that we consider the question of whether, under these facts, the inclusion of COR in the ARAM calculation as directed by Commission 2 in its Period A decision constitutes a normalization violation.

Section 4.01(6) of Rev. Proc. 2020-39, 2020-36 I.R.B. 546, provided transition rules due to the reality that many utilities had already been required to adjust rates due to the TCJA. According to this provision in Rev. Proc. 2020-39, “[u]tilities may correct any method of reversing ETR that is not in accord with this revenue procedure at the next available opportunity. The methods adopted prior to the publication of this revenue procedure that are not in accord with this revenue procedure are not considered to be a violation of the Normalization Rules if so corrected. This corrective action will require the utility to consult with its regulator and obtain its regulator’s consent. Utilities are not in conflict with section 13001(d) of the TCJA if the utilities follow such a path to correct potential normalization violations prospectively. These rules extend to companies that may not have started the amortization of ETRs or may be re-deferring the amortization as they evaluate their records.”

Additionally, § 168(f)(2) itself 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. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Commission 2 has not required or insisted upon treatment by Taxpayer that it knows is noncompliant with the Normalization Rules. Rather, Commission 2 recognized that the matter was not clear at the time and recommended that Taxpayer seek a ruling from the Service. Further, Commission 2 has directed Taxpayer to comply with the Service's interpretation of the applicable tax laws by filing with Commission 2 to seek an appropriate adjustment to its revenue requirement and/or rate base in the event that Taxpayer requests and receives a private letter ruling from the IRS.

Taxpayer's failure to comply with the Normalization Rules was inadvertent. Because Commission 2, as well as Taxpayer, has at all times sought to comply, and because corrective actions will promptly be taken, Taxpayer's use of the method proposed by Commission 2 does not constitute a normalization violation.

CONCLUSIONS:

Based on the foregoing, we conclude as follows:

1) Commission 2's method of including COR in the ARAM for the return of the EDFIT to ratepayers is inconsistent with the Normalization Rules.

2) Taxpayer's method of excluding COR from the ARAM computation for return of the EDFIT to ratepayers is consistent with the Normalization Rules.

3) As stated in Conclusion 1, the method proposed by Commission 2 is inconsistent with the Normalization Rules. However, Taxpayer's use of the method proposed by Commission 2 as reflected in Commission 2's Period A decision, is not a violation of the Normalization Rules, provided Commission 2 (i) approves the method proposed by Taxpayer (or otherwise required by the Service) and (ii) allows Taxpayer to recover any difference in the rates charged to customers under Commission 2's proposed method and the Taxpayer's method.

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.

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,

/s/

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

cc: