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Date:

March 22, 2021

In Re:

LEGEND:

Taxpayer	=
Parent	=
Commission A	=
Commission B	=
State A	=
State B	=
Electric Division	=
Gas Division	=
Date 1	=
Year A	=
Year B	=
Director	=

Dear

This letter responds to a request for a private letter ruling dated September 24, 2020, and submitted on behalf of Taxpayer regarding the application of the depreciation normalization rules under § 168(i)(9) of the Internal Revenue Code (the Code) and § 1.167(l)-1 of the Income Tax Regulations (together, the "Normalization Rules") to certain State A state regulatory procedures which are described in this letter. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer is an investor-owned “combination” regulated utility that is incorporated and operates in State A. It is an indirect, wholly-owned subsidiary of Parent, a State B corporation. Taxpayer is included on the consolidated federal income tax return of Parent. Through its Electric Division, Taxpayer is engaged in the business of generation, purchase, transmission, distribution and sale of electric energy. Through its Gas Division, Taxpayer is engaged in the purchase, distribution, and sale of natural gas. Taxpayer employs the accrual method of accounting and reports on the calendar year basis. Both Divisions of Taxpayer are subject to regulation by Commission A. Rates for both divisions are set on a “rate of return” basis.

Taxpayer has claimed accelerated depreciation on its public utility properties to the full extent allowed by the Code. Taxpayer has normalized the federal income taxes deferred in accordance with the Normalization Rules. Consequently, Taxpayer has a substantial balance of Accumulated Deferred Federal Income Taxes “ADFIT” attributable to accelerated depreciation reflected on its regulated books of account for both divisions. In accordance with ratemaking practices under Commission A, Taxpayer has included its ADFIT balance in its capital structure as cost-free capital.

Commission B has, by regulation, established Uniform Systems of Accounts “USOAs” which are applicable to both divisions of Taxpayer. 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 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 plant.

and “depreciation” as:

... the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric 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 of an asset at the end of its life is incorporated into the annual depreciation charge. COR is, therefore, a component of establishing the applicable depreciation rate. Both Divisions of Taxpayer break out the COR and salvage rates separately from depreciation. The net rate is considered the Life Rate that is approved by Commission A. The COR and salvage reserves are tracked separately from accumulated depreciation in Taxpayer’s continuing property records.

Since depreciation expense is included in Taxpayer’s cost of service used for establishing its rates, customers pay for the COR as book depreciation in their rates. However, for tax purposes, COR is deductible only when actually incurred. Therefore, for tax purposes, Taxpayer 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. Since COR is normalized in setting rates, customers are provided a tax benefit commensurate with their funding of COR.

Accounting Standards Codification “ASC” 98-740-25-2, which is followed by the Taxpayer, provides that if, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes would be recovered from or returned to customers through future rates, an asset or liability shall be recognized for that probable future revenue or reduction in future revenue. Moreover, that asset or liability also shall be a temporary difference for which a deferred tax liability (DTL) or asset shall be recognized.

The tax effect of recovering COR through rates before the associated tax deduction can be claimed creates a deferred tax asset (DTA). This represents the future benefit to be derived from the eventual COR tax deduction.

Since Year A, Taxpayer has been able to separately identify the portion of its accumulated book depreciation reserve that relates to the COR accrual balance. Consequently, Taxpayer distinguishes between COR book/tax differences and depreciation method/life differences even though they are both derived from Taxpayer’s book depreciation rates and expense. Taxpayer’s system can, therefore, track the reversals of these differences separately.

Taxpayer's Recent Commission A Proceedings

On Date 1, Commission A opened two dockets for Taxpayer for the purpose of identifying and quantifying the potential impact of the TCJA on both Divisions of Taxpayer tax-related costs and to determining a method of incorporating that impact into their respective rates. Among the impacts considered was quantification of the deferred federal income taxes previously provided that, as a result of the tax rate reduction enacted by the TCJA, are no longer necessary to fund the reversal of prior timing differences (Excess Deferred Federal Income Taxes "EDFIT"). As a component of this amount, Taxpayer calculated its Excess Tax Reserve "ETR" as defined in Section 13001(d) of the TCJA. Taxpayer also quantified the effect of applying the Average Rate Assumption Method "ARAM" to that reserve. Since, by statute, the ETR consists only of ADFIT required to be provided under the Normalization Rules, the ARAM is only mandatorily applicable to such ADFIT.

One of the issues Taxpayer had to consider in computing its ETR in each of the dockets was whether or not the ADFIT shortfall created by COR is "protected". Taxpayer concluded that COR is not subject to the Normalization Rules because it is not a depreciation life/method difference. It, therefore, treated the COR-related ADFIT shortfall as unprotected in each of the two dockets. Consistent with this view, Taxpayer believes that the recovery of the COR-related ADFIT shortfall from customers is not constrained by the Normalization Rules.

RULINGS REQUESTED

Taxpayer requests the following guidance:

- 1) Under the circumstances described above, is Taxpayer's COR-related deferred tax shortfall "protected" by the Normalization Rules?
- 2) If Taxpayer's COR-related deferred tax shortfall is "protected," should that shortfall be treated as a discrete "protected" item or as part of the "protected" method/life difference?
- 3) If Taxpayer's COR-related deferred tax shortfall is "protected," do the Normalization Rules permit Taxpayer to collect that shortfall any more rapidly than using the ARAM?

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 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). 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.

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. Moreover, there is no reference to an acceleration of taxes but only to a deferral. While COR may be a component of the calculation of the amount treated as book depreciation, it is a deduction under § 162 and has nothing to do with actual accelerated tax depreciation. While depreciation method and life differences 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. Prior to Year B, Taxpayer paid income tax at a rate of 35% rate on the receipt of the COR portion of book depreciation (and provided its customers a tax benefit at that rate) from its customers. However, as a result of the tax rate reduction enacted as part of the TCJA, Taxpayer will receive a 21% benefit when the COR deduction is actually claimed. Thus, the situation is precisely the opposite from that of method/life differences where accelerated deductions produced a 35% tax benefit but, when reversed, will become subject to only a 21% income tax. Thus, in the case of COR, the tax rate reduction enacted as part of the TCJA produced a deferred tax shortfall, not an excess deferred tax reserve. Because Taxpayer will not recover the 14% “excess” tax it paid on its recovery of the COR component of book depreciation from the government when it claims its COR deduction, it may recover this amount from its customers consistent with the Normalization rules.

Based on the foregoing, we conclude that:

1) Under the circumstances described above, Taxpayer's COR-related net DTA is not "protected" by the Normalization Rules.

Because the amounts in request 1 are not protected by the Normalization Rules, requests 2 and 3 are moot.

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,

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

cc: