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CC:PSI:B06
PLR-114851-99

Date:

May 23, 2006

Re: Request for Private Letter Ruling Regarding Normalization

Legend
Taxpayer =
Parent =
Corporation =
State1 =
State2 =
State3 =
City =
County =
A =
B =
C =
D =
E =
F =
G =
H =
I =
J =
K% =
L =
M =
N =
O =
P =
Q =
R =
S =
T =

U =
V =
W =
X =
Y =
Z =
AA =
BB =
CC =
DD =
EE =

Dear :

This letter responds to a letter dated September 1, 1999, submitted on behalf of Taxpayer, relating to the normalization requirements under former section 46(f)(2) of the Internal Revenue Code and section 203(e) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 (the "Act"), for accumulated deferred investment tax credit ("ADITC") and excess deferred federal income taxes ("EDFIT") associated with certain generation assets that were sold by Taxpayer.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is a public utility incorporated in State1 on A. Taxpayer is engaged in the business of furnishing electricity, gas and steam utility services to the general public within City and County. It is a subsidiary of Parent, a public utility holding company under the Public Utility Holding Company Act of 1935. Parent was incorporated in the State1 on B. Parent files a consolidated federal income tax return (Taxpayer is a member of the consolidated group) with the Internal Revenue Service.

Corporation is a regulated public utility incorporated in State1 on C. Corporation wholly owns two public utility subsidiaries, a State2 electric utility company and a State3 electric and gas company. On D, Parent acquired all of the stock of Corporation. Corporation is now a wholly owned subsidiary and files a consolidated federal income tax return. As a result of Parent's purchase of Corporation, Corporation will file a short period federal income tax return for year ended D and thereafter will be part of Parent's consolidated tax group.

In E, the F began proceedings with respect to restructuring the State1 electric industry to foster competition in the generation of electricity and offer customers a choice of energy providers. On G, the F issued it's order in those proceedings. The order endorsed a fundamental restructuring of the electric utility industry in State1, based on competition in the generation and energy service sectors of the industry. The

F directed Taxpayer, Corporation and most of the other electric utilities in State1 subject to the proceedings to file restructuring plans by H, addressing, among other things, retail access, divestiture of electric generation, and a corporate reorganization. Taxpayer and Corporation filed their plans on H.

With respect to Taxpayer, F issued an order on I that adopted and incorporated the terms of a settlement agreement dated J, among Taxpayer, the F staff and other parties. The terms of the settlement agreement included a requirement of divestiture by Taxpayer to unaffiliated third parties of at least K% of its City electric generating fossil-fueled capacity.

On L, Taxpayer filed a divestiture plan with the F. Pursuant to the divestiture plan, Taxpayer proposed to divest its City electric generating capacity, which totals approximately M megawatts. This capacity is divided into the N bundle, the O bundle, and the P bundle. The N bundle included the N generating facility located in Q and R gas turbines located at the facility. The O bundle included the O generating facility located in Q and a total of S gas turbines. The P bundle included the P generating facility in U and V gas turbines located in Q. In addition, the divestiture plan identified properties that are available for sale to third parties for the purpose of constructing new generating facilities. Following the sale of the three asset bundles, Taxpayer will solicit offers for its potential generating sites from all bidders. By a subsequent order issued and effective on W, F ordered the sale of all of the Taxpayer's City electric generating fossil-fueled capacity to third parties. The divestiture of Taxpayer's electric generation included its X interest in the Y generating facility in Z that it co-owned with Corporation, which owned the remaining AA interest.

On BB, Taxpayer sold the N generating facility and its associate gas turbines. On CC, Taxpayer sold the P generating facility and its associated gas turbines. On DD, Taxpayer sold its interest in Y. On EE, Taxpayer sold the O generating facility and its associated gas turbines.

Taxpayer accounts for its investment tax credit pursuant to an election under section 46(f)(2) of the Code. At the time of the sales, Taxpayer had recorded on its books amounts of deferred income taxes, excess deferred income taxes, and accumulated deferred investment tax credits relating to the public utility property disposed of in the sales.

RULINGS REQUESTED

Taxpayer requests the Internal Revenue Service issue the following rulings:

1. Taxpayer will violate the normalization requirements of former section 46(f)(2) of the Code if the unamortized ADITC remains on Taxpayer's regulated books of accounts and continues to be amortized against operating tax expense thereby reducing cost of service; and

2. Taxpayer will violate the normalization requirements of section 168(i)(9) of the Code if the EDFIT reserves, which Taxpayer has removed from its regulatory books of account, are used, directly or indirectly, to reduce its rate base or cost of service (or treat it as zero cost of capital).

LAW AND ANALYSIS

The first determination involves whether Taxpayer, an elector under section 46(f)(2), will violate the normalization requirements if the unamortized ADITC associated with assets sold remains on Taxpayer’s regulated books of accounts after the asset sale and continues to be either credited to ratepayers or continues to be amortized against operating tax expense.

Former section 46(f)(2) provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former § 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former § 46(a) and allowable by § 38. Also, under former § 46(f)(2)(B), no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former § 46(a) and allowable by § 38.

Former section 46(f)(6) provides that for purposes of determining ratable portions under former § 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under section 1.46-6(g)(2) of the Income Tax Regulations, “ratable” for purposes of former § 46(f)(2) is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

Section 46(f)(2) of the Code states that a taxpayer satisfies the normalization requirements if the cost of service is reduced by no more than the ratable portion of the investment tax credit. Ratable is determined under section 1.46-6(g)(2) by reference to the period of time actually used in computing a taxpayer’s regulated depreciation expense for the property for which the credit is allowed. Accordingly, as long as the investment tax credit is amortized no more rapidly than over the period actually used for regulated depreciation purposes, the ratemaking treatment of the credit will comply with the normalization requirements.

The method prescribed by § 1.46-6(g)(2) for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the ADITC is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of former § 46(f)(2) are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case, Taxpayer has sold the assets that generated the ADITC and, as a result, the assets for which regulated depreciation expense is computed are no longer available and therefore, there is no correlation between the assets and the credits. Thus, if any portion of the unamortized ADITC associated with the assets sold is used to reduce Taxpayer’s cost of service, directly or indirectly, the requirements of section 46(f)(2) will be violated.

The second determination involves whether Taxpayer will violate the normalization requirements of section 168(i)(9) if the EDFIT reserves, which Taxpayer has removed from its regulatory books of account, is used, directly or indirectly, to reduce its rate base or cost of service (or treat it as zero cost of capital).

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, section 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 section 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 section 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.

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 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 under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period of depreciation used in determining the allowance for depreciation under § 167(a).

Section 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

Section 203(e)(1) of the Act provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or section 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 excess tax reserve more rapidly or to a greater extent than this reserve would be reduced under the average rate assumption method ("ARAM").

The term "excess tax reserve" is defined in § 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former § 167(l)(3)(G)(ii) or § 168(e)(3)(B)(ii) as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is 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 that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) 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;

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of section 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that § 203(e) of the Act does not modify the normalization requirements of former section 167(l) or of section 168(i).

For a public utility to use accelerated depreciation in determining its federal income tax liability, section 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under § 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to a utility’s customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, section 203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to a utility’s customers in the form of reduced rates.

The impact of section 203(e) of the Act is that if Taxpayer were to improperly treat its excess deferred taxes and violate the normalization rules, it would not be permitted to use the most favorable method of depreciation under the modified asset recovery system (MACRS) provisions of section 168 with respect to its public utility property. As a result, Taxpayer would be required to use less favorable methods of depreciation, thus increasing its federal income tax liability.

In the present case, Taxpayer has sold the aforementioned public utility property. Retirements of public utility property subject to the normalization requirements of section 168 are reflected in adjustments to Taxpayer’s deferred tax reserve as well as its excess tax reserve (see section 1.167(l)-1(h)(2)(i) and Rev. Proc. 88-12, 1988-1 C.B. at 638). As a result of the sale, these reserves cease to exist. A violation of the depreciation normalization will occur if there is any reduction to Taxpayer’s rate base, after the sale date, of the unamortized EDFIT reserve attributable to accelerated depreciation on public utility property that is sold. Furthermore, a normalization violation will also occur if Taxpayer, in computing its cost of service, reduces its EDFIT reserve more rapidly than its reserve would be reduced under the ARAM. Under the ARAM, the EDFIT reserve is reduced over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. Further, ARAM relies on mechanisms requiring a regulatory life. Once the property is sold, as is the case with Taxpayer herein, the regulatory life ceases to exist. Therefore, there can be no subsequent reduction in the cost of service on account of the EDFIT reserve without violating the normalization requirements.

CONCLUSIONS

Hence, with respect to the rulings requested by Taxpayer, a normalization violation will occur if Taxpayer reduces cost of service by the ADITC in respect of assets sold and likewise, such a violation will occur if Taxpayer reduces rate base or cost of service by the EDFIT reserve in respect of the assets sold.

Based solely on the representations and the relevant law and analysis set forth above, we conclude that:

(1) Taxpayer will violate the normalization requirements of section 46(f)(2) of the Code if the unamortized ADITC remains on Taxpayer's regulated books of accounts and continues to be amortized against operating tax expense thereby reducing cost of service, and

(2) Taxpayer will violate the normalization requirements of section 168(i)(9) of the Code if the EDFIT reserves, which Taxpayer has removed from their regulatory books of accounts, are used, directly or indirectly, to reduce their rate base or cost of service (or treat it as zero cost of capital).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer and to another of Taxpayer's authorized representatives. We are also sending a copy of this letter to the Industry Director, Natural Resources and Construction (LM:NRC).

Sincerely,

Peter C. Friedman

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

Enclosures (2)
copy of this letter
copy for section 6110 purposes