

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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CC: PSI: B06 – PLR-101933-03

Date:

January 13, 2004

In Re:

Private Letter Ruling Request on
Normalization

Taxpayer =

Commission =

Department =

State X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

\$B =

\$C =

Dear :

This letter is in response to your letter dated December 2, 2002, requesting a ruling under the normalization requirements of former section 167(l) and section 168(i)(9) of the Internal Revenue Code with respect to the accumulated deferred federal income tax (“ADFIT”) reserve attributable to property that is removed from Taxpayer’s regulated books of account.

Taxpayer represents that the facts are as follows:

Taxpayer is the parent company of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting. Taxpayer is a regulated public utility engaged in, among other things, the generation, transmission, distribution, and sale of electrical energy.

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In State X, Taxpayer provides electric distribution and transmission services and is regulated by the Commission. Taxpayer's rates in State X are established and approved by the Commission on a "rate of return" basis.

On Date 1, the Commission ordered audits of both the electric transmission and electric distribution plant accounts of Taxpayer in State X. The purposes of the audit were (1) to support and establish proper depreciation rates for future ratemaking, and (2) to identify and remove from regulated plant accounts any assets not in service, not properly identified, not verifiable, or not properly includible as transmission and distribution assets.

The final audit reports (one for transmission plant and one for distribution plant) issued on Date 2 and Date 3, respectively, recommended adjustments in Taxpayer's regulated plant accounts based on the physical inventory and independent valuation conducted by the auditors. The adjustments to these plant account balances resulted from Taxpayer not properly maintaining its plant accounts. Following the issuance of the audit report, Taxpayer and the Department, among others, entered into a settlement agreement.

Pursuant to the settlement which is pending before the Commission, property in the amount of \$B ("Excluded Property") will be removed from Taxpayer's regulated books of account. However, the accumulated depreciation associated with the Excluded Property will not be removed from Taxpayer's regulated books of account.

In Date 4, Taxpayer initiated a rate case in State X with respect to its State X electric division. In its initial rate case filing, Taxpayer excluded from its computation of regulated rate base the Excluded Property in accordance with the settlement referred to above. As noted above, the accumulated depreciation reserve in rate base was not adjusted for the accumulated depreciation reserve on the Excluded Property. Taxpayer did not reflect regulatory depreciation associated with the Excluded Property in either its regulated depreciation expense or in its computation of regulated tax expense. Additionally, Taxpayer removed the ADFIT reserve associated with the Excluded Property (in the amount of \$C) from its computation of regulated rate base.

The Department took the opposite position on the ADFIT reserve associated with the Excluded Property and sought to have this ADFIT reserve maintained on Taxpayer's regulated books of account to serve as a reduction to rate base. However, in its final order dated Date 5, the Commission adopted Taxpayer's position and agreed to the removal of the ADFIT reserve associated with the Excluded Property, but ordered Taxpayer to submit a letter ruling request to the Internal Revenue Service for the purpose of determining whether adoption of the Department's proposed treatment of the

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ADFIT reserve associated with the Excluded Property violates the normalization requirements.

Ruling Requested

Accordingly, Taxpayer seeks the following ruling:

Would the maintenance of the ADFIT reserve associated with the Excluded Property on Taxpayer's regulated books of account and its reflection in the computation of regulated rate base constitute a violation of the normalization rules under former section 167(l) and section 168(i)(9) of the Code, and section 1.167(l)-1(b) and 1.167(a)-11(b)(6) of the Income Tax Regulations?

Law and Analysis

Section 168(i)(10) of the Code 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 of 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.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in section 167(l)(3)(A) of the Code and section 168(i)(10) which defined public utility property by means of a cross reference to section 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b)(1) of the regulations provides that under section 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a section 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale have been established or approved by a regulatory body described in section 167(l)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body that has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the

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meaning of section 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) of the Code requires the taxpayer, in computing its tax expense for purposes of 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 no shorter than, the method and period used to compute its depreciation for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 with respect to public utility property differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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) of the Code provides that one way in which the requirements of section 168(i)(9)(A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with the requirements of section 168(i)(9)(A). Section 168(i)(9)(B)(ii) provides that the procedures and adjustments that are to be treated as inconsistent for purposes of section 168(i)(9)(B)(i) shall include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to the rate base.

Former section 167(l) of the Code generally provides that public utilities are entitled to use accelerated methods of depreciation if they use a "normalization method of accounting." A normalization method of accounting is defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). According to former section 167(l)(3)(G), the consistency requirements of section 168(i)(9)(B) apply to former section 167(l).

Section 1.167(l)-1(h)(1)(i) of the regulations 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) of the regulations 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

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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) of the regulations 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(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 section 167(a).

Section 1.167(a)-11(b)(6) of the regulations provides similar rules for public utility property subject to depreciation under the Class Life Asset Depreciation Range System (CLADR).

In the present situation, Taxpayer's rate base, tax expense, and depreciation expense for ratemaking purposes will be determined without the cost of the Excluded Property. If the ADFIT reserve associated with the Excluded Property is not removed from Taxpayer's regulated books of account and is used to reduce Taxpayer's rate base, the consistency requirement of section 168(i)(9)(B) will be violated because Taxpayer will not include the cost of the Excluded Property in its rate base or include the amount of related depreciation in its computation of tax expense and depreciation expense for ratemaking purposes.

Ruling

Based solely on Taxpayer's representations and the law and analysis as set forth above, we conclude that the maintenance of the ADFIT reserve associated with the Excluded Property on Taxpayer's regulated books of account and its reflection in the computation of regulated rate base would constitute a violation of the normalization rules under former section 167(l) and section 168(i)(9) of the Code, and sections 1.167(l)-1(b) and 1.167(a)-11(b)(6) of the regulations.

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code or regulations. This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

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In accordance with the power of attorney on file, a copy of this letter is being sent to Taxpayer's authorized legal representative.

Sincerely yours,

Kathleen Reed
KATHLEEN REED
Senior Technician Reviewer
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter

Copy for section 6110 purposes