200004038

Internal Revenue Service

Department of the Treasury

Index Number: 168.24-01
46.01-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:6 PLR-105884-99

Date: OCT 26 1999

Re: Private Letter Ruling Request on Normalization of Investment Tax Credit and Average Rate Assumption Method Benefits

Taxpayer =

Parent =

District =
Bill =
State =
Date 1 =
Date 2 =
a =
b =
c =

Dear :

This letter responds to the request of Taxpayer, dated March 12, 1999, and supplemental information submitted on behalf of Taxpayer, for a determination as to the normalization requirements under § 46(f)(2) of the Internal Revenue Code and § 203(e) of the Tax Reform Act of 1986 for the accumulated deferred investment tax credit ("ADITC") and average rate assumption method ("ARAM") benefits associated with certain generation plants that were sold by Taxpayer. Specifically, Taxpayer has asked the Internal Revenue Service to rule on three issues:

1. For plants that are sold at a net after-tax book gain, whether there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances existing at the date of sale are incorporated in the gain on sale computation and returned to ratepayers through a Transition Cost Balancing Account ("TCBA").

24

2. For plants that are sold at a net after-tax book loss, whether there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances existing at the date of sale are incorporated in the loss on sale computation and returned to ratepayers by amortizing those amounts to a TCBA.

3. Alternatively, if ruling number two above is deemed to be a normalization violation, whether a proportionate part of the ADITC and ARAM benefits may be returned to ratepayers without causing a normalization violation. For purposes of this ruling, the proportionate part of the ADITC and ARAM benefits to be returned to ratepayers is based on the percentage of the plant cost remaining at the date of sale which is paid for by ratepayers through the loss recovery mechanism.

Taxpayer represents that the facts and information relating to its request are as follows:

Taxpayer is 100 percent owned by Parent and files a consolidated Federal income tax return with Parent. Taxpayer is under the audit jurisdiction of the District Director of District.

On Date 1, Bill became effective in State. Bill initiated changes to the regulated electric utility market structure and it permitted customer choice of electric generation providers. Any stranded costs caused as a result of the deregulation are to be collected from ratepayers on a nonbypassable basis. The recovery of costs from ratepayers, however, shall not extend beyond Date 2 ("transition recovery period"). Whatever stranded costs are not recovered during the transition recovery period will not be eligible for recovery from ratepayers and will be absorbed by Taxpayer's shareholders.

As a result of Bill, Taxpayer sold all a of its oil and gas fired generation stations to unrelated third parties. Of the plants that were sold, b were sold for a net book gain and c were sold for a net book loss. The cumulative result was a net book gain. Prior to the sale of the plants, stranded costs were being amortized over the transition recovery period.

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) of the Code 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.

2 4 C

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.

Section § 168(i)(9)(B)(i) of the Code 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) of the Code 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 of the Income Tax Regulations 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)(l)(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)(l)(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 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 tax 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 shall not be reduced except to reflect the amount for

752

any tax 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)(l)(i) or to reflect depreciation used in determining the allowance for depreciation under § 167(a).

The first determination involves the proper normalization treatment by Taxpayer, a § 46(f)(2) elector, of its ADITC relating to its oil and gas fired generation stations that were sold to unrelated third parties.

Section 46(f) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, § 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 § 46(a) and allowable by § 38. Also, under § 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 § 46(a) and allowable by § 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable portions under § 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 § 1.46-6(g)(2) of the Income Tax Regulations, "ratable" for purposes of § 46(f)(2) of the Code 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 expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratable 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 account 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 expenses without reduction for salvage or other items such as over and under accruals.

The method prescribed by § 1.46-6(g)(2) of the regulations 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 § 46(f)(2) of the Code 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 asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those amounts to a TCBA.

The second determination involves the proper normalization treatment by Taxpayer of average rate assumption method ("ARAM") benefits relating to its oil and gas fired generation stations that were sold to unrelated third parties.

Section 203(e)(1) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 ("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 § 167 or § 168 of the Code 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 that this reserve would be reduced under the average rate assumption method.

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) of the Code 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 § 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 § 167(l) or § 168(i) of the Code.

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its Federal income tax liability, § 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 the 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, § 203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

75

In the present case, Taxpayer has sold the aforementioned public utility assets. Retirements of public utility property subject to the normalization requirements of § 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see § 1.167(l)-1(h)(2)(i), and Rev. Proc. 88-12, 1988-1 C.B. 637, at 639). As a result of the sale, these reserves cease to exist. A violation of the normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

Hence, in each of the three rulings requested by Taxpayer, there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances (or a proportionate part thereof) existing at the date of sale are returned to ratepayers by amortizing those amounts to a TCBA. Since Taxpayer has sold the assets that generated the ADITC, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those amounts to a TCBA. Additionally, a violation of the normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property.

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.

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

Sincerely yours,

/S/ Peter C. Friedman
PETER C. FRIEDMAN
Assistant to the Branch Chief, Branch 6
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
6110 copy