**Internal Revenue Service**

Number: **200632006**
Release Date: 8/11/2006
Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-113442-99

Date:
May 08, 2006

LEGEND:

Taxpayer =

State =

Commission =

Act =

Plan =

Plants =

Date =
x =
y =

Director =

Dear . :

This letter responds to the request, dated July 30, 1999, of Taxpayer for a ruling on the proper treatment of two of Taxpayer's deferred tax accounts. The accounts are excess deferred federal income tax (EDFIT), consisting of deferred taxes described in § 203(e) of the Tax Reform Act of 1986, and accumulated deferred investment tax credits (ADITC) under former § 46(f) of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer is an investor-owned electric company incorporated under the laws of State. Taxpayer's primary business has traditionally been the generation, transmission, and distribution of electric power. It is subject to the regulatory jurisdiction of Commission with regard to its retail rates and certain conditions of service.

State enacted the Act, providing for restructuring of electric utilities in State. Act requires generally that, as a condition of seeking recovery of "stranded costs,"[1] an electric utility divest or attempt to divest its non-nuclear generation assets in a public auction approved by Commission. Taxpayer submitted Plan to Commission, proposing to auction Plants, its non-nuclear generating facilities. Commission approved Plan and the Plants were auctioned, the sale closing on Date. Although the sale has been completed, the treatment of EDFIT of x and ADITC of y with respect to the Plants will be determined based on the outcome of this ruling request.

Commission staff has proposed that Taxpayer reflect the reversal of the EDFIT and ADITC balances to increase its computation of net gain on the sale of Plants, where such net gain will be used to reduce those stranded costs that will be recovered from Taxpayer's distribution customers, thus using the EDFIT and ADITC to indirectly benefit ratepayers after the sale of the assets which gave rise to those amounts. Taxpayer had argued to the Commission that any ratemaking treatment that directly or indirectly retained the economic benefits of the unamortized ADITC and EDFIT for ratepayers upon the sale of the Plants would violate the normalization provisions of the Code. Taxpayer has been directed by the Commission to request a ruling concerning whether a final determination put into effect by Commission requiring Taxpayer to flow the unamortized ADITC and EDFIT balances to ratepayers, directly or indirectly, following the sale of Taxpayer's generation assets pursuant to the State restructuring laws, would violate the normalization rules set forth in former section 46(f)(2) and section 168(i)(9).

[1] In the context of electric industry restructuring, stranded costs are those costs incurred or contracted for by a utility in the context of traditional regulation that the utility will not be economically able to recover after full or partial deregulation.

The first issue involves the proper normalization treatment by Taxpayer of unamortized EDFIT relating to the sale of its Plants.

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 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 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 section 168 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 the requirements of section 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 section 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 section 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) 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(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 section 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) 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(1)-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 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(1)-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(1)-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 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

According to section 203(e)(1) of the Act, 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 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 (ARAM).

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

(i) the reserve for deferred taxes as described in former section 167 (1)(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 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 section 203(e) of the Act does not modify the normalization requirements of former section 167(l) or section 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, 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 section 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, section 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.

In the present case, Taxpayer has sold the Plants. Retirements of public utility property subject to the normalization requirements of section 168 are reflected in adjustments to the deferred tax reserve as well as its excess tax reserve (see section 1.167(1)-1(h)(2)(i), and Rev. Proc. 88-12, 1988-1 C.B. at 638). As a result of the sale, the reserves cease to exist. A violation of the normalization rules will occur if there is any reduction to Taxpayer's rate base, after the sale date, for the unamortized EDFIT reserve attributable to accelerated depreciation on public utility property. This is true even where such a reduction is indirect, such as where the net gain on the sale of Plants is used to reduce stranded costs of EDFIT that would otherwise be recovered from ratepayers in the future. 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.

Thus, Taxpayer will violate the requirements of the depreciation normalization rules set forth in former section 167(l), section 168, and section 203(e) of the Act, if it increases net gain from the sale of the Plants by EDFIT associated with the Plants where such net gain is used to reduce stranded costs to be collected from Taxpayer's remaining distribution customers.

The second issue involves the proper normalization treatment by Taxpayer of ADITC relating to the sale of its Plants.

Former 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, 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 section 38. Also, under former section 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 section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 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 regulations, "ratable" for purposes of former section 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 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.

The method prescribed by section 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 investment tax credit 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 section 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 Plants, the assets that generated the investment tax credit 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 used to directly or indirectly reduce Taxpayer's cost of service.

Thus, Taxpayer will violate the requirements of the investment tax credit normalization rules set forth in former section 46(f), if it increases the net gain from the sale of the Plants by the ADITC associated with the Plants where such net gain is used to reduce stranded costs to be collected from Taxpayer’s remaining distribution customers.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technican Reviewer, Branch 6
(Passthroughs & Special Industries)

cc: