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April 18, 2012

In Re: Consequences of Taxpayer's accounting and regulatory treatment of the § 48A Credit

Legend:

Taxpayer =

Parent =

Owner X =
Commission A =
Commission B =
Commission C =
State A =
State B =
Facility =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Month 1 =
Month 2 =
Month 3 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
a% =

$b =
c% =
$d =
$e =
$f =
$g =
h =

Dear :

This letter responds to your request dated December 5, 2011, requesting rulings on whether the disallowance provisions of § 46(f)[1] of the Internal Revenue Code of 1986 (the Code) apply to Taxpayer as a result of Taxpayer's accounting and regulatory treatment of its § 48A Qualifying Advanced Coal Project Credit.

Taxpayer represents that the facts are as follows:

Taxpayer is an integrated, regulated public electric utility incorporated and headquartered in State A. Taxpayer is principally engaged in the generation, transmission, distribution and sale of electricity in States A and B. Commission A, Commission B, and Commission C regulate Taxpayer, with respect to the terms and conditions of its services, including the rates it may charge for such services. Taxpayer's rates are established on a "rate of return" basis in each of these regulatory jurisdictions.

Taxpayer is a wholly-owned subsidiary of Parent, and Parent includes Taxpayer in Parent's consolidated federal income tax return that Parent files on a calendar year basis. Taxpayer employs the accrual method of accounting and likewise reports on a calendar year basis. For purposes of the investment tax credit (ITC) normalization rules under former § 46(f) of the Code, Taxpayer elected to account for its accumulated deferred ITC in ratemaking on public utility property in accordance with former § 46(f)(2).

Taxpayer's public utility property includes a a% interest in Facility, a coal-fired generating facility. Taxpayer's cumulative investment in Facility at Date 4 was $b. Taxpayer developed and operates Facility; however, Facility has several owners including Owner X with c% ownership.

Taxpayer filed an application with the Internal Revenue Service (IRS) and Department of Energy for § 48A Qualified Advanced Coal Project Credits (§ 48A Credit or § 48A Credits). Taxpayer's application was accepted and Taxpayer was allocated $d of § 48A Credits for the Facility. At the time Taxpayer filed the initial application, none of the other Facility owners applied for the § 48A Credits.

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[1] The relevant portions of § 46(f) of the Code were repealed by the Revenue Reconciliation Act of 1990, Pub. L. 101-508. However, under § 50(d)(2), those provisions still apply with respect to property on which a regulated utility claimed the investment tax credit.

Taxpayer and the IRS entered into a memorandum of understanding (MOU) regarding the allocation of the § 48A Credits. That same month, Taxpayer announced in its Form 10-Q filing that it had been awarded $d of § 48A Credits. Owner X immediately notified Taxpayer that it intended to file a notice of controversy under the Facility operating and ownership agreement related to the § 48A Credits. Owner X sought either a reallocation of a portion of the § 48A Credits from Taxpayer to Owner X or the monetary equivalent under the terms of the operating and ownership agreement.

Owner X filed a notice to arbitrate the § 48A Credits issue under the ownership and operating agreement. The arbitration order ruled in favor of Owner X. The arbitration order required Taxpayer to request that the IRS reallocate $e of § 48A Credits to Owner X, and if Taxpayer were unsuccessful, the arbitration order required Taxpayer to pay the amount in cash to Owner X. As a result of the arbitration order, the IRS and Taxpayer agreed in a revised MOU to reallocate $e of the § 48A Credits to Owner X, reducing the amount of § 48A Credits allocated to Taxpayer from $d to $f.

Taxpayer made an election in Month 2 of Year 2 under § 48A(b)(3) of the Code to begin taking qualified progress expenditures ("QPE") for the Facility on its originally filed Year 1 federal income tax return. Under § 48A(b)(3), taxpayers may take QPE into account as qualified investment in computing the § 48A Credits under the rules set forth under former § 46(d)(6) as in effect on the day before the enactment of the Revenue Reconciliation Act of 1990. In accordance with the QPE election and the revised MOU, Taxpayer claimed the § 48A Credits on its federal income tax returns for Years 1, 2, and 3. Parent, however, has only used the § 48A Credits of Year 1, $g to reduce Parent's consolidated federal tax liability. Parent, on a consolidated basis, was not able to use the § 48A Credits that Taxpayer claimed on its tax returns in Years 2 and 3 to reduce its consolidated federal income tax liability. Parent carried forward the § 48A Credits, and Parent currently does not project to fully use the § 48A Credits until several tax years later. On Date 3, Taxpayer placed Facility in service for tax purposes. In Month 2 of Year 4, Taxpayer began amortizing a ratable portion of its revised § 48A Credits, $f, on its regulatory books of account over the book life of Facility.

Taxpayer filed a new rate case for State B in Month 3 of Year 3, which included a test year based on the twelve months ending Date 1, and for State A in Month 1 of Year 4 which included a test year based on the twelve months ended Date 2.

When Taxpayer filed the initial rate application, Taxpayer included a ratable portion of the entire $d of § 48A Credits in calculating income tax expense on the cost of service schedules because at that time the original MOU entitled Taxpayer to claim and fully use the entire $d in § 48A Credits. Commission B knew of the attempt to reallocate the § 48A Credits, but Taxpayer received the revised MOU after the hearings for the rate case were complete and the rate case was closed. Therefore, Commission B used the original MOU in effect at the time of the rate filing and hearings in setting Taxpayer's rates. Taxpayer filed a petition for reconsideration and clarification on various matters including its request to reduce ITC amortization to reflect the revised MOU.

Commission B denied Taxpayer's request as a procedural matter because Taxpayer and the IRS signed the revised MOU after the period of discovery for the rate case.

Commission B concluded that Taxpayer would have an opportunity to correct this error in a subsequent rate case or other appropriate rate proceeding. Commission B stated that it was not its intent to capture Facility's advanced coal investment tax credits more rapidly than the IRS allows. Commission B Order on Petitions for Reconsideration and Clarification dated Date 5. Additionally, Commission B allowed Taxpayer to record a regulatory asset/liability on its books to track the excess amount of ITC amortization that would occur so that Taxpayer can recover it in its next rate case.

Taxpayer also included a ratable portion of the entire $d of § 48A Credits in calculating income tax expense on the cost of service schedules it prepared when filing its initial application for the State A rate case. The State A case, however, allowed for a "true-up" period, and Taxpayer was able to reduce the amount of § 48A Credits included in the cost of service computations to be in line with the revised MOU.

In addition, Taxpayer inadvertently amortized § 48A Credits that Parent has not used as an offset against federal tax liability on a consolidated basis. Taxpayer should have included only a ratable portion of the § 48A Credits that Parent has used to offset federal tax liability, $g, in Taxpayer's regulatory books of account and on its Commission B and Commission A rate applications. Instead, Taxpayer began to amortize the full amount of its § 48A Credits, $f, on its books and records. This error occurred over a h period.

Taxpayer contacted Commission B and Commission A about this error. Due to the timing of Taxpayer's discovery of the error, both the Commission B staff and Commission A staff indicated that they will allow Taxpayer to request a reduction of its amortization concerning this issue in its next appropriate rate proceeding.

In an effort to address the impact of this error, Taxpayer made an adjustment to "reverse" the excess § 48A Credits that Taxpayer amortized on its books and records as of Date 6 to restore the cumulative balance of the unamortized § 48A Credits. The entry involved a charge to income tax expense to reverse the income statement impact and a credit to the accumulated § 48A Credit deferred ITC accounts. As a result, Taxpayer's balance of unamortized § 48A Credits deferred ITC and its cumulative income tax expense are stated as they would have been had Taxpayer only amortized h of $g of § 48A Credits.

Accordingly, Taxpayer has requested the following rulings:

1) Taxpayer is in compliance with the normalization requirements with respect to ITC amortization of § 48A Credits used in the State B rate order, rather than the reduced amount pursuant to the revised MOU. The final allocation will be reflected in the next rate proceeding, and Commission B will allow Taxpayer to recover in the next

rate proceeding the amount by which the amortization of § 48A Credits ultimately reallocated reduced rates charged pursuant to the rate proceeding.

2) Inadvertent ITC amortization of § 48A Credits that have yet to be realized in its State B and State A rate cases and on its regulatory books of account is not inconsistent with the ITC normalization requirements, and that no disallowance or recapture of ITC is required.

Law and Analysis

Under § 46(3) of the Code, for purposes of § 38, the amount of the investment credit determined under this section for any taxable year shall be the sum of several credits including the qualifying advanced coal project credit provided by § 48A.

Section 48A(a) of the Code provides, in part, that the qualifying advanced coal project credit for any taxable year is an amount equal to 15-percent of the qualified investment for such taxable year in the case of projects which use advanced coal-based generation technologies other than integrated gasification combined cycle projects.

Under § 50(d) of the Code, credits listed as ITC under § 46 including § 48A Credits are subject to the normalization rules of former § 46(f) in effect on the day before the enactment of the Revenue Reconciliation Act of 1990.

In general, the ITC was introduced in 1962 and repealed for years after 1985 by the Tax Reform Act of 1986. Former § 46(f) of the Code and § 1.46-6 of the Federal Income Tax Regulations (Regulations) provide limitations on the use of tax credits by public utilities. Former § 46(f)(1) provides a general rule that disallows tax credits for "public utility property" if, for ratemaking purposes, such investment tax credit is used to reduce the taxpayer's cost of service or to reduce the taxpayer's rate base unless such base rate reduction is restored ratably, or faster, over the property's useful life for ratemaking purposes.

As noted earlier, Taxpayer elected to account for its investment credit on public utility property in accordance with former § 46(f)(2) of the Code. Former § 46(f)(2) provides an election for ratable flow through under which an elector may flow through the ITC to cost of service. However, former § 46(f)(2)(A) provides that no ITC 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 ITC 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.

Section 1.46-6(a)(3) of the Regulations provides that the provisions of former § 46(f)(2) of the Code are limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. If an election is made under former § 46(f)(2), the credit may be flowed through to income, but not more rapidly than ratably, and there may not be any reduction in rate base.

Former § 46(f)(6) of the Code 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 § 1.46-6(g)(2) of the Regulations, "ratable" for purposes of former § 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 ratably in proportion to the number of such units.

Section 1.46-6(f)(4) of the Regulations provides that the ITC is disallowed for any § 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with § 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with § 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) of the Regulations provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's § 46(f) property.

Section 1.46-6(f)(8)(1) of the Regulations provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2) of the Code. For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1st Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under § 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

Taxpayer prepared cost of service schedules for the State B rate case hearings based upon the original MOU, and these cost of service schedules were those in effect during the State B rate case hearings. Taxpayer petitioned for reconsideration based on the revised MOU, but Commission B denied its request because the MOU was revised after the rate order hearings were complete. Accordingly, both Taxpayer and Commission B were using the information in effect at the time. Neither Taxpayer nor Commission B intended for Taxpayer to include more than a ratable portion of the actual § 48A Credits that were ultimately allocated to Taxpayer. Moreover, neither Taxpayer nor Commission B intended to cause a normalization violation for Taxpayer. In addition, Commission B is expected to allow Taxpayer to reflect the final allocation in the next rate proceeding and recover the amount by which the amortization of the original credit amount reduced rates to ratepayers. Finally, Commission B is allowing Taxpayer to record a regulatory asset/liability on its books to track the excess amount of ITC amortization.

Taxpayer inadvertently amortized § 48A Credits that Parent has not yet used as an offset against federal tax liability on its consolidated tax return. Taxpayer made this error because it originally anticipated that Parent would be able to use the full credit; however, the extension of bonus depreciation on qualified additions for tax years 2010 through 2012 and the increase of bonus depreciation to 100% for certain 2010 through 2012 additions changed this projection. Additionally, Taxpayer was not aware that the ITC should not reduce cost of service in a period before Taxpayer's Parent used the credit as an offset against federal income tax on its consolidated return. Taxpayer independently discovered the error and acted upon its discovery. Taxpayer contacted the Commission A and B staffs, and both indicated that they will allow Taxpayer to request a reduction of its amortization with respect to this issue in its next appropriate rate proceeding. Neither Taxpayer nor Commissions A or B intended to cause a normalization violation for Taxpayer. Additionally, Taxpayer has made an adjustment to "reverse" the excess § 48A Credits that Taxpayer amortized on its books and records.

We conclude that Taxpayer's actions as described above are not inconsistent with the requirements of former § 46(f) of the Code. In accord with the Senate Reports quoted above, the harsh sanction of disallowance or recapture of the ITC should be imposed, if at all, only after a regulatory body has required or insisted upon such treatment by a utility. Because Commissions A and B did not require or insist on the errors discussed above, no disallowance or recapture is required in this case.

This ruling is conditioned upon Commissions A and B allowing Taxpayer to take the corrective actions as Taxpayer has described in its representations in the prior paragraphs. Specifically, Commission B must allow Taxpayer to reflect the final § 48A

Credit allocation in the next rate proceeding and recover the amount by which the amortization of the original credit amount reduced rates to ratepayers. Additionally, both Commissions A and B must allow Taxpayer to request a reduction of its amortization in its next appropriate rate proceeding due to Taxpayer inadvertently amortizing § 48A Credits that Parent has not yet used as an offset against federal tax liability on its consolidated tax return. This letter ruling will be null and void and will have no effect if any of these conditions do not occur.

We based the rulings contained in this letter upon information and representations that Taxpayer and its representatives submitted, and accompanied by penalties of perjury statements that Taxpayer executed. 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.

Except as specifically set forth above, we express no opinion concerning the federal income tax consequences of the facts or transactions described above under any other provision of the Code.

We direct this ruling only to the taxpayer who requested it. Under § 6110(k)(3) of the Code, a letter ruling may not be used or cited as precedent.

In accordance with a power of attorney on file in this office, we are sending a copy of this letter ruling to your authorized representatives.

Sincerely,

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

Enclosures (2):
Copy
Copy for § 6110 purposes

cc: