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Date:
January 18, 2013

LEGEND:

Taxpayer	=
Parent	=
State A	=
State B	=
Commission A	=
Commission B	=
Operator	=
Facility	=
Year A	=
Year B	=
Year C	=
Year D	=
Year E	=
A	=
Date X	=
Date Y	=
Director	=

Dear :

This letter responds to the request, dated August 10, 2012, of Taxpayer for a ruling on the consequences of Taxpayer's accounting and regulatory treatment of the Investment Tax Credit (ITC).

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A. It is an indirect wholly-owned subsidiary of Parent, which is incorporated in State B. Taxpayer is included in the consolidated federal income tax return of Parent. Taxpayer is principally engaged in the generation, transmission, distribution, and sale of electricity in State A, as well as the wholesale sales of electric energy and various transmission services at negotiated rates under the jurisdiction of Commission B. Taxpayer is regulated with respect to the terms and conditions of service and, most particularly, regarding the rates it may charge for its services by Commission A and Commission B. Taxpayer is a member of Operator, an independent transmission system operator. With respect to the jurisdiction of each of the commissions, Taxpayer's rates are determined using a "rate of return" basis that allows Taxpayer to earn a reasonable rate of return. Taxpayer has elected to account for its ITC pursuant to former § 46(f)(2).

Taxpayer is constructing the Facility. Taxpayer received an allocation of investment tax credit provided for under §48A(d)(3)(B)(i) of $A. Taxpayer claimed the credit on its tax return in Year A and Year B as the Facility was being constructed. It was anticipated at the time that the Facility would be placed in service in Year C. Taxpayer has not yet offset any of the credit amount against its tax liability due to limitations on use of the ITC contained in § 38(c). Taxpayer has additional unamortized accumulated deferred ITC relating to generation, transmission, and distribution assets placed in service prior to 1986.

With respect to wholesale electric activities, Taxpayer negotiates rates with wholesale customers using a formula rate structure approved by Commission B. The formula is periodically updated, resulting in changes to rates. With respect to transmission activities, formula rates have been employed by Taxpayer since Year D. The tariff that Taxpayer may charge its wholesale customers and third parties for their use of these transmission assets, the Open Access Transmission Tariff (OATT), is regulated by Commission B. In establishing its OATT rates, Taxpayer uses a template approved by Commission B that was developed by Operator. Formula rates, in general, allow for self-executing adjustments to rates on an annual basis to reflect increases and decreases in costs and investments since the prior year. They incorporate a calculation of both rate base and tax expense. Thus, they reflect Taxpayer's ADITC balance as well as the amount being amortized.

Taxpayer's rates were established using procedures consistent with former § 46(f)(2), meaning that Taxpayer reduced the tax expense element of cost of service by no more than a ratable portion of its ITC and that Taxpayer did not reduce rate base by any portion of the ADITC balance. Under this provision, in no event can ITC be reflected in the rate-setting process until the later of (1) the placement in service of the asset which generated the credit or (2) the use of the credit on a taxpayer's tax return.

Taxpayer has determined that, with respect to the sales of energy and other services under the jurisdiction of Commission B, the template Taxpayer used to establish both its wholesale electric rates (beginning in Year E) and its OATT rates (beginning in Year D) reflected its ADITC balance as a reduction in rate base. Further, the amortization of Taxpayer's ADITC balance was not reflected as a reduction in tax expense. In addition, beginning in Year A, Taxpayer's ADITC balance was increased to reflect the ITC claimed with respect to Facility. This also reduced rate base in the calculation of rates for the activities under the jurisdiction of Commission B. Here too, the tax expense element of cost of service was not reduced on account of any amortization of Taxpayer's ADITC balance. The effect of Taxpayer's treatment of its ADITC in the rate templates was a reduction in rates to wholesale customers

The formula templates were completed by Taxpayer's regulatory personnel and they did not recognize the normalization issues raised. Personnel in Taxpayer's tax department became suspicious and reviewed the use of the templates by regulatory personnel. Once they became aware of the errors, Taxpayer corrected all relevant aspects of its rate filings prospectively, beginning with the filings made on Date X, effective for rates in effect as of Date Y. Commission B did not specifically address or consider any of the rates or calculations at issue here in any order to Taxpayer.

Law and Analysis

Former section 46(f)(2) 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.

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

Section 1.46-6(f)(2) 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) provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2). 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, 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 section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

For the periods during which Taxpayer erroneously calculated the template and thus improperly reduced rate base, the practical effect of this error was to lower rates and thus, to flow the ITC to its customers more rapidly than if the template had been correctly applied. This reduction was not the intent of either the Taxpayer or Commission B. Further, Taxpayer has acted upon discovery of these errors and adjusted its rates so that they now reflect the same amounts as if no errors had occurred. We conclude that Taxpayer's actions as described above are not inconsistent with the requirements of former § 46(f). Finally, Commission B never specifically addressed these matters in a rate case involving Taxpayer and so did not issue and order on these matters during this period. In accord with the Senate Reports quoted above, disallowance or recapture of the ITC should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. Because Commission B did not insist on the errors discussed above, no disallowance or recapture is required in this case.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, orders concerning this matter finalized by either of the Commissions after the date of this ruling are not necessarily subject to the same analysis as those considered above.

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 Technician Reviewer, Branch 6
(Passthroughs & Special Industries)

cc: