

## Internal Revenue Service

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February 20, 2019

## LEGEND

Taxpayer =

Company =

Corporation =

Division =

Group =

State A =

State B =

Commission A =

Commission B =

Director =

a =

b =

c =

d =

e =

f =

g =

h =

Month 1 =

Month 2 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Schedule =

Dear :

This letter responds to a request for a private letter ruling dated July 18, 2018, submitted on behalf of Taxpayer by your authorized representative. Taxpayer requested a ruling regarding the application of the depreciation normalization rules under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (the Normalization Rules.) The relevant facts as represented in your submission are set forth below.

### FACTS

Taxpayer is incorporated in State A. Taxpayer employs a calendar year reporting period and uses the accrual method of accounting.

Taxpayer is an indirect subsidiary of Company. Company owns subsidiaries other than Taxpayer. Company is a% owned by Corporation. Corporation is the parent of an affiliated group of corporations that files a consolidated Form 1120, U.S. Corporation Income Tax Return, and this group includes both Company and Taxpayer and their respective subsidiaries.

Taxpayer is a regulated public utility principally engaged in the business of generating, transmitting, distributing, and selling electricity. It serves retail customers in portions of several states. Taxpayer also sells electricity in the wholesale market. In connection with these activities, Taxpayer is regulated with respect to the terms and conditions of service and, most particularly, as to the rates it can charge for its services by the state public utility regulator in each state in which it operates as well as by Commission A. In each regulatory jurisdiction, Taxpayer's rates for retail electric service are determined on a "cost of service" basis and are designed to provide, after recovery of allowable operating expenses, an opportunity to earn a reasonable return on "rate base."

This ruling request seeks guidance in connection with Taxpayer's utility operations in State B which is subject to regulation by Commission B. The division of Taxpayer that operates in State B is named Division.

Taxpayer has claimed and continues to claim accelerated depreciation, including bonus depreciation allowed by § 168(k) of the Code ("Bonus"), on all of its public utility property to the full extent those deductions are available under the Code. In all of its

regulatory jurisdictions, Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of accumulated deferred federal income tax (“ADFIT”) that is attributable to accelerated depreciation reflected on its regulated books of account. In State B, as well as in other jurisdictions in which Taxpayer operates, this ADFIT balance is used to reduce Taxpayer’s rate base upon which it is permitted to earn a return.

Bonus was scheduled to expire for assets placed in service after . Bonus was later extended for assets placed in service during the entire calendar year by virtue of the enactment of Sec. 125 of the Tax Increase Prevention Act (“TIP”), which was signed into law on December 19, 2014. This legislation retroactively extended Bonus for assets placed in service during all of . The following year, Bonus was again retroactively extended for assets placed into service during the entire calendar year by virtue of the enactment of Sec. 143 (Div. Q) of the Protecting Americans from Tax Hikes Act of 2015 (“PATH”), which was signed into law on December 18, 2015. Thus, during both and , the law did not permit Taxpayer to claim Bonus for the year on property placed in service during the year until the time of the TIP and PATH enactment dates, respectively.

The Accounting Standards Code (“ASC”) establishes generally accepted accounting principles (“GAAP”). According to ASC 740-10-25-47 and 740-10-25-48, a portion of the section of the ASC that prescribes accounting for income taxes, state, respectively:

- The effect of a change in tax laws or rates shall be recognized at the date of enactment.
- The tax effect of a retroactive change in enacted rates on current and deferred tax assets and liabilities shall be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment.

Accordingly, prior to mid-December of and , it was not permissible for Taxpayer to recognize Bonus-related ADFIT for financial reporting purposes relating to assets placed in service in those years. Accordingly, in and , Taxpayer recognized the ADFIT attributable to Bonus on both its financial and regulatory books of account only in December. Commission A has adopted this aspect of the GAAP rules applicable to accounting for income taxes through its adoption of ASC 740 into its Uniform System of Accounting. Commission B has adopted Commission A accounting rules.

### Rate Cases

In Month 1 Year 1, Division applied to Commission B for an increase in retail electric rates. The test period used in the Year 1 General Rate Case (“GRC”) was the twelve-month period ending Date 1. The rate effective date was Date 2. For purposes of computing all elements of rate base (including ADFIT), Division used a 13-month average. In its application (which was filed prior to the passage and signing of the TIP Act), Division’s ADFIT component of rate base was computed consistent with its financial and regulatory books of account at the time. Therefore, it was computed based on the fact that it was not, at the time, entitled to Bonus on any property placed in service in Year 1 or Year 2. Commission B issued its Findings of Fact, Conclusions of Law, Decision and Order on Date 3 (“Year 1 Order”) with a slightly revised *Nunc Pro Tunc* version of the Year 1 Order issued on Date 4.

Less than two weeks prior to the issuance by Commission B of the Year 1 Order, enactment of the TIP Act extended Bonus to all qualified Year 1 depreciable additions. Taxpayer recognized the effect of this legislation in its ADFIT accounts in Month 2 Year 1, the month in which the extension of Bonus was enacted.

In Month 1 Year 2, Division again applied to Commission B for an increase in retail electric rates. Commission B ultimately determined to use a calendar year Year 2 test year in the Year 2 GRC. The rate effective date was Date 5. For purposes of computing all elements of rate base (including ADFIT), Division used a 13-month average.

In its filing, Division’s ADFIT component of rate base was computed consistent with its financial and regulatory books of account. Therefore, it was computed based on the fact that it was not, at the time, entitled to Bonus on any property placed in service in Year 2. Commission B issued its Memorandum Opinion, Findings of Fact, Decision and Order (“Year 2 Order”) on Date 6.

Less than two weeks prior to the issuance by Commission B of the Year 2 Order, the PATH Act extended Bonus to all qualified Year 2 depreciable additions. In accordance with GAAP, Taxpayer recognized the effect of this new legislation in its ADFIT accounts in Month 2, the month in which the Bonus extension was enacted.

#### Taxpayer’s Deferred Accounting Order and Sur-Credit

On Date 7, Group, a group of Division’s retail customers, petitioned Commission B for rehearing and requested that Commission B adjust Division’s revenue requirement effective Date 2 to reflect Taxpayer’s ability to claim Bonus on Year 1 additions. Commission B denied the petition, but determined that the benefits from the extension of Bonus should be passed on to customers and stated that the extension of Bonus could be addressed in Division’s already filed, subsequent rate case (Year 2 GRC) and/or through a deferred accounting order (DAO) proceeding that Group had simultaneously initiated.

On Date 8, Group filed a petition requesting that Commission B order Division to calculate the difference between the revenues collected from customers based on the test period revenue requirement set by Commission B in the Year 1 GRC on the presumption that Bonus was not allowed for all Year 1 additions and the revenue requirement on the presumption that Bonus was allowed for all Year 1 additions, with all other things being held constant. This amount would be recorded as a regulatory liability and interest calculated thereon. By means of a DAO dated Date 9, Commission B imposed such an accounting requirement on Division. This DAO did not impact rates charged at any time during Year 2 and so Year 2 rates never reflected the availability of Bonus for Year 1 plant additions.

When the Year 2 Order was issued, Commission B caused Year 3 rates to incorporate a sur-credit to compensate customers for the fact that rates charged during Year 2 did not reflect the fact that Taxpayer was ultimately able to claim Bonus on its Year 1 additions. In order to implement the sur-credit, Division created Schedule, which tracked the amount due customers. Division calculated this amount to be \$b plus interest.

On Date 10, and pursuant to the Year 2 GRC Order, Division applied to Commission B to reduce the revenue requirement adopted in its Year 2 GRC on account of the PATH Act's extension of Bonus. Division calculated the amount that still remained due to customers as of the end of Year 3 on account of the Year 1 Bonus extension, \$c, and added to it an amount due on account of the Year 2 Bonus extension, \$d. Division requested authorization to sur-credit this amount, \$e, back to customers beginning Date 11 with carrying charges, \$f, for calendar year Year 4 which together totaled \$g. In a subsequent amendment, Division proposed the sur-credit back to customers begin Date 12 instead of Date 11 and revised the amount to be sur-credited back to customers during Year 4 to \$h.

### Dispute

During this proceeding, a dispute arose over the proper method of computing the amount due customers on account of the two Bonus extensions.

When Division recomputed its revenue requirement as if Bonus had been available, it did so based on the timing of the statutory enactment and resulting recognition of the effect of Bonus on its books and records. In each case, Taxpayer recognized the ADFIT impact based on the legislative enactment date, as required under GAAP. Thus, Taxpayer recognized the ADFIT impact of each of the Bonus extensions starting in Month 2 of the relevant year, the month in which each of the extensions became law. Taxpayer did not recognize any impact of bonus depreciation attributable to the retroactive nature of the extension in each portion of the test period prior to the month of enactment. Therefore, Taxpayer recognized the impact of the

retroactive extension going forward as soon as the law changed (in Month 2 of each of the two years) but recognized no impact of the retroactive extension for all months prior to the date of enactment. Taxpayer then averaged the relevant 13 monthly ADFIT balances to derive an annual average ADFIT balance.

Group disputed this methodology. It proposed that the impact of the Bonus extension in each year be reflected over the entire test period. More specifically, Group argued that Bonus impacted and should be accrued from the legislative effective date of the extension – in each case, as of January 1 of the tax year for which Bonus was extended. Thus, for each of the GRCs, the extension impact would be reflected in each month of the test year.

Taxpayer contended that the Group proposal would create a violation of the Normalization Rules. Group contended it would not.

On Date 13, Commission B ordered that, subject to application for and receipt of an Internal Revenue Service private letter ruling addressing Taxpayer's normalization concerns, computation of the revenue requirement adjustment resulting from Bonus extensions should be reflected in Schedule employing Group's proposed methodology. As part of that order, Commission B required that the related reduction in revenue requirement be held in abeyance until Taxpayer secures a private letter ruling from the Internal Revenue Service regarding whether or not the reduction in rate base as of the effective date (as opposed to the enactment date) of the extension of Bonus constitutes a normalization violation. This ruling request was filed pursuant to that order.

#### RULING REQUESTED

Whether the regulatory treatment as determined and ordered by Commission B which requires that rate base be reduced by ADFIT to reflect bonus depreciation from the legislative effective date on which bonus depreciation is applied, rather than from the enactment date upon which bonus depreciation became available, complies with the Normalization Rules.

#### LAW

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 § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(1)-1(a)(1) 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 168(f)(2) 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) requires that a 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, 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 § 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) 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.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. In this case, the regulatory treatment ordered by Commission B complies with the consistency requirement of § 168(i)(9)(B).

## CONCLUSION

Accordingly, the regulatory treatment as determined and ordered by Commission B which requires that rate base be reduced by ADFIT to reflect bonus depreciation from the legislative effective date on which bonus depreciation is applied, rather than from the enactment date upon which bonus depreciation became available, complies with the Normalization Rules.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.



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.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. 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.

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 Director.

Sincerely,

Patrick S. Kirwan  
Chief, Branch 6  
Office of Chief Counsel (Passthroughs &  
Special Industries)

cc: