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Date:
November 16, 2021

In Re: Ruling Request under the Normalization Rules

LEGEND:

Subsidiary	=
Taxpayer	=
Division 1	=
Division 2	=
Combined Division	=
Commission	=
Docket	=
Order 1	=
Order 2	=
State A	=
State B	=
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Dear :

Your representatives requested a ruling on behalf of Subsidiary, a subsidiary of Taxpayer regarding the application of deferred tax assets ("DTA") for net operating loss ("NOL") carryforwards under the tax normalization rules of § 167(l) of the Internal Revenue Code of 1986, as amended ("Code") and § 1.167(l)-1(h)(1)(iii) of the Income Tax Regulations (collectively, "Normalization Rules") to certain accounting and regulatory procedures which are described in detail hereafter.

Taxpayer is headquartered in State A and includes Subsidiary, among other companies (collectively referred to as the "Group"). The Group operates its own regulated water and wastewater systems and provides non-regulated water and wastewater services to other companies, municipalities, and agencies.

Subsidiary is a public utility that provides water service in State B. Subsidiary has several divisions including Division 1 and Division 2. Division 1 and Division 2 combined represent Combined Division to which this request relates.

Combined Division's existing utility rates and charges are based on its Date 1 through Date 2 test year rate case which represents Combined Division's most recent rate case.

On Date 3, the Commission granted Combined Division's motion to waive the requirement to utilize mid-year Year 1 through Year 2 test year data in support of its Application. As a result, the Commission authorized Combined Division to utilize Year 1 calendar year test year financial data in its Application. On Date 4, Combined Division filed its Month Application with amended material filed on Date 5 (collectively, "Application"). Pursuant to the rules of State B, Combined Division sought review and approval by the Commission of a Date 6 through Date 7 test year ("Test Year") net overall revenue increase of $a for its consolidated operations which Combined Division represents is approximately a b% increase from its pro forma revenue amount of $c at present rates for the Test Year. More specifically, Combined Division's requested increase is comprised of proposed increases of (1) $d, or approximately e%, for water service; and (2) $f, or approximately g% for sewer service. Combined Division represented that, if approved, the requested increase would provide Combined Division "with a h% rate of return" on its prudently incurred system improvements. In support of its requested rate increase, Combined Division states that:

(1) "[its] current rates do not now and will not in the foreseeable future produce sufficient revenues to allow it a reasonably opportunity to earn a fair rate of return on its prudently incurred investment [,]"
(2) it "has made significant capital improvements and plans to make additional capital improvements in the Test Year [,]" and
(3) "[its] operating expenses have increased since its last rate case."

For calendar year Year 3, on a pro forma basis, Combined Division represents that it had: (1) revenues of approximately $i and a j% rate of return for its water service and revenues of approximately $k and a l% rate of return for its sewer service. For the Test Year, Combined Division "projects revenues of approximately $m and a n% rate of return at present rates for its water service, and revenues of approximately $o and a p% rate of return at present rates for its sewer service.

The rate case uses calendar year Year 1, and rates are intended to go into effect in Year 2 which represents a historic tax period. During the course of the rate case, a Consumer Advocate opposed certain rate case positions and computations. The Commission adopted the Consumer Advocate's position on certain rate case positions and computations of which Combined Division is concerned could result in a violation of Normalization Rules. As a result, Combined Division has proposed and adopted an interim rate adjustment to the Commission adopted rates until it is determined through this ruling request that the positions adopted by the Commission are consistent with the Normalization Rules. If there is an adverse ruling request, the rates will be adjusted to comply with this ruling and become final at that point.

On December 22, 2017, the President signed the Tax Cuts and Jobs Act ("TCJA") into law, effective January 1, 2018. On Date 8, the Commission opened a Docket to investigate the impacts of the TJCA and named Combined Division as a party to the proceedings. Among other matters, the TCJA significantly reduced the federal corporate income tax rate from 34% to 21%. As such, on Date 8, the Commission issued Order 1, naming all regulated utilities as parties to the docket, and ordered them to (1) immediately begin tracking the impacts of the TCJA, as of January 1, 2018; and (2) use deferred regulatory account practices, such as the use of regulatory assets and liabilities, to record the differences resulting from the TCJA and what would have been recorded if the TCJA did not go into effect. The Commission also stated that further direction would be provided regarding the final utility rate adjustments as a result of the TCJA through subsequent orders in dockets outside of Docket (that is, in rate cases or order to show cause proceedings).

Taxpayer maintains its books and records on a consolidated basis but can compute its books and records on a separate company basis, or what would have been reported to the IRS had Taxpayer been required to file a separate company return. The separate company books and records indicate that Combined Division would have a NOL DTA of $q and a deferred tax liability ("DTL") of $r. The NOL presented on a separate company basis for Subsidiary is allocated back to individual divisions based on their respective contribution to the taxable loss from Year 4 to Year 5. The dispute between Taxpayer and the Commission is based on the allocation of the separate company NOL DTAs to the divisions and the availability of those to offset DTLs.

At the Taxpayer consolidated level, there is a NOL. However, for State B purposes the NOL attributable to Subsidiary is computed on a separate company basis consistent with how financial items are treated for ratemaking purposes in State B. The Subsidiary separate company NOL is then allocated among those districts that have contributed based on their individually calculated division taxable losses. The Commission's position is that no NOL DTA is necessary to be allocated to the individual Subsidiary divisions for ratemaking purposes.

Treatment of Excess Accumulated Deferred Income Taxes ("EADIT")

Subsidiary has established a deferred liability for the EADIT that would result from the reduction in the federal income tax rate resulting from the TCJA. Subsidiary maintains its books and records on a separate company basis for regulatory reporting. As of Date 9, Subsidiary's books reflected $r in deferred income tax which represents the DTL. Additionally, there was a DTA of $q which represented the NOL from Year 4 to Year 5. When a utility records a NOL, the Normalization Rules mandate it be offset against deferred income tax liabilities to the extent it is attributable to accelerated depreciation. Since Subsidiary keeps its books and records on a separate company basis, the $q NOL was allocated back to individual divisions based on their respective contribution to the taxable loss from Year 4 to Year 5. Next, excess DTL was calculated for each division. If the allocated NOL that is attributable to accelerated depreciation

was greater than the DTL for the respective company/divisions, there is no excess DTL. If the NOL was less than the DTL, the NOL was offset against the DTL and the adjusted DTL was remeasured. The difference between the adjusted DTL and remeasured DTL represented excess DTL. Based on the analysis there was no excess DTL for Division 1 or Division 2. Stated alternatively, Combined Division would have sufficient NOL attributes to offset the reversal of DTL balances which indicates that a NOL would have occurred regardless of the temporary adjustments.

Dispute between Combined Division and Consumer Advocate

Combined Division proposed that the NOL DTA should be used to reduce the DTL offset to rate base. This is based upon the belief that a DTL represents a cost-free source of capital in which the utility has recovered from ratepayers both current and deferred taxes, although deferred taxes shall be remitted to a taxing authority in a future tax year. The DTL shall serve as an offset to rate base to the extent it is a cost-free source of capital and only then until the DTL reverses and taxes are renumerated. A NOL represents an unfunded portion of a DTL in which there shall be no economic effect until the NOL offsets taxable income and reduces a tax liability in a future tax period. The cost-free source of capital only occurs to the extent a true deferral of tax liability occurs, which does not occur when accelerated tax deductions result in a NOL.

Combined Division believes that if a NOL DTA balance exceeds the DTL balance, that current taxes have been brought to zero dollars and does not burden the ratepayer. Also, Combined Division believes that deferred taxes that have been brought to zero because a NOL DTA balance exceeding the DTL balance indicates that pre-tax book income was a negative balance and results in zero current or deferred taxes burdening the ratepayer.

Therefore, Combined Division believes that to the extent a DTL is fully offset or exceeded by a NOL DTA that is attributable to accelerated depreciation, which Combined Division believes is the case using the “with or without” method, then the ratepayer has not been burdened by a tax liability since the NOL DTA will not have economic substance until it offsets taxable income in the future. Under this treatment, the deferred tax adjustment to offset rate base shall equal the DTL balance plus the NOL DTA balance attributable to accelerated depreciation.

In the present case, Combined Division represents through their rate proceeding a $s NOL DTA for Division 1 and $t NOL DTA for Division 2 compared to a DTL balance of $u and $v respectfully. Therefore, Combined Division represents there is a zero excess DTL balance to offset rate base. The NOL DTA represents an allocation from Subsidiary to each division and the DTL balance is reflective of temporary differences booked to the individual divisions.

The Consumer Advocate contended that Combined Division’s proposed treatment of EADIT allows regulated treatment of Combined Division’s parent

company's unrelated loss that results in ratepayers not receiving any of the excess amounts already collected by Combined Division that should be returned to customers.

Commission's Discussion, Findings, and Conclusions Regarding EADIT

The Commission adopted the treatment and computation of EADIT consistent with the Consumer Advocate's position. As a result, the Commission determined that Combined Division would have to treat EADIT in the following manner:

1. Combined Division shall reduce rate base by the amount of EADIT for water and sewer operations to reflect the TCJA deferred tax adjustment [reduce rate base by only the DTL disregarding the NOL DTA] consistent with the Consumer Advocate's position regarding the treatment of EADIT, as adopted by the Commission.
2. Combined Division shall refund, as a monthly surcredit, the total amortization of protected and unprotected EADIT to customers. Once Combined Division provides the necessary support for the various amounts shown in its calculation of EADIT between the two categories (protected and unprotected), there should be a reconciliation of the amounts returned to customers and the verified EADIT. Any difference would be subject to interest.
3. Combined Division shall recalculate EADIT, TCJA deferred tax adjustment, and the amortization of protected and unprotected EADIT for both water and sewer operations, consistent with the Consumer Advocate's position on the treatment of EADIT adopted by the Commission, with the terms of the relevant order.

Combined Division is aware of the potential of a violation of Normalization Rules specific to the methodology of excluding the NOL DTA balance to offest rate base. Therefore, Combined Division has proposed an interim rate adjustment to the Commission. The Commission has approved the interim rate adjustment in Order 2.

RULINGS REQUESTED

The Taxpayer requests the following guidance:

1) Is Commission's determination of EADIT without regard to a consolidated NOL DTA consistent with the Normalization Rules?
2) Is Combined Division's position with regard to a consolidated NOL DTA being required to be allocated to its members consistent with the Normalization Rules?
3) Under Taxpayer's facts, must the NOL of a consolidated group be allocated to its subsidiaries for purposes of complying with the Normalization Rules?
4) Is the computation of a NOL attributable to a subsidiary taxpayer of a consolidated group on a separate return methodology consistent with the Normalization Rules?

5) Under Taxpayer's facts, must the consolidated NOL appropriately attributable to Subsidiary be allocated to Subsidiary's multiple divisions (including Combined Division) when those divisions are subject to separate rate filings?
6) Is it consistent with the Normalization Rules that the separate company NOL be allocated to divisions based on the ratio of division taxable income to the separate company during the period of losses from Taxpayer's records?
7) Is the allocable portion of a NOL deduction associated with accelerated depreciation determined on a "with or without" basis consistent with the Normalization Rules?
8) Under the Taxpayers facts, including Taxpayer's allocation of the NOL to separate divisions, would the failure to account for the portion of the NOL related to accelerated tax depreciation in calculating the amount of DTL to offset rate base of Combined Division be inconsistent with the Normalization Rules?

LAW AND ANALYSIS

Section 168(f)(2) of the 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. 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(a)(1) of the

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)(1)(i) 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)(1)(iii) 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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a NOL carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) 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, with respect to any account, the aggregate amount allocable to deferred tax under § 167(l) shall not be reduced except 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. That section also notes 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 § 1.167(l)-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 § 167(a).

Section 1.167(l)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of § 1.167(l)-(h), a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of

return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of § 1.167(l)-(h)(6), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Therefore, § 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Rev. Proc. 2020-39, 2020-36 I.R.B. 546, provides, in part, in section 4.02 that, “[w]hile § 1.167(l)-1(h)(1)(iii) is the relevant general authority, there is not one single methodology provided for determination of the portion of an NOLC that is attributable to depreciation. Section 1.167(l)- 1(h)(1)(iii) instead informs taxpayers that the amount and time of the deferral of tax attributable to depreciation when there is an NOLC should be taken into account in such ‘appropriate time and manner as is satisfactory to the district director.’ Regulating commissions have expertise in this area, and any reasonable method for determining the portion of the NOLC attributable to depreciation should generally be respected provided such method does not clearly violate normalization requirements.” Use of a “with and without” methodology in this case is a reasonable method that provides certainty and prevents the possibility of “flow through” of the benefits of accelerated depreciation to ratepayers.

Subsidiary has established a deferred liability for the excess deferred income taxes that would result from the reduction in the federal income tax rate. The DTL serves as an offset to rate base to the extent it is a cost-free source of capital. A NOL represents an unfunded portion of a DTL in which there is no economic effect until the NOL offsets taxable income and reduces a tax liability in a future tax period. This offset, and therefore the economic effect of the DTL as a cost-free source of capital only occurs to the extent an actual deferral of tax liability occurs. A deferral does not occur when accelerated tax deductions result only in a NOL. Because the EADIT account reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the EADIT account. Therefore, in this case, Taxpayer knows the amount of NOL DTA that is attributable to accelerated depreciation for its subsidiaries including Combined Division. A DTL shall serve as an offset to rate base to the extent it is a cost-free source of capital. The ratepayers of Combined Division have not been burdened by a tax liability since the NOL DTA will not have economic substance until it offsets taxable income in the future.

Because Taxpayer has this information at the division level for Combined Division, it must use this information to ensure its method correctly calculates the amount of the NOLC attributable to accelerated depreciation and thus prevents the possibility of flow through. Taxpayer’s failure to take into account a portion of NOLs attributable to accelerated depreciation in calculating the amount of DTL would be inconsistent with the Normalization Rules.

CONCLUSION

Based on the foregoing, we conclude as follows:

1) The Commission’s determination of EADIT without regard to a consolidated NOL DTA is inconsistent with the Normalization Rules.
2) Combined Division’s position with regard to a consolidated NOL DTA being required to be allocated to its members is consistent with the Normalization Rules.
3) Under Taxpayer's facts, the NOL of a consolidated group must be appropriately allocated among its subsidiaries for purposes of complying with the Normalization Rules.
4) The computation of a NOL attributable to a subsidiary taxpayer of a consolidated group on a separate return methodology is consistent with the Normalization Rules.
5) Under Taxpayer's facts, the consolidated NOL appropriately attributable to Subsidiary must be allocated to Subsidiary’s multiple divisions (including Combined Division) when those divisions are subject to separate rate filings.
6) It is consistent with the Normalization Rules that the separate company NOL be allocated to divisions based on the ratio of division taxable income to the separate company during the period of losses from Taxpayer’s records.

7) The allocable portion of a NOL deduction associated with accelerated depreciation determined on a “with or without” basis is consistent with the Normalization Rules.
8) Under the Taxpayers facts, including Taxpayer’s allocation of the NOL to separate divisions, the failure to account for the portion of the NOL related to accelerated tax depreciation in calculating the amount of DTL to offset rate base of Combined Division would be inconsistent 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 requesting it. Section 6110(k)(3) of the Code provides that 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 representatives.

Sincerely,

/S/

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

Enclosure:
Copy for § 6110 purposes

cc: