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December 21, 2021

Legend

Taxpayer	=	
Corporation	=	
Consolidated Group	=	
Commission A	=	
Commission B	=	
State	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Month	=	
Date 1	=	
Date 2	=	
a	=	
b	=	
Decisions	=	

Dear :

A ruling has been requested on behalf of Taxpayer regarding the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code of 1986, as amended ("Code"), Treas. Reg. § 1.167(l)-1, former § 167(l) of the Code, and section 13001(d) of the Tax Cuts and Jobs Act, Pub. L. 115-97, (the "TCJA") (collectively, the "Normalization Rules") to the calculation of the method used by Commission A in a recent rate proceeding to reflect federal income tax expense reductions for Taxpayer for excess deferred income taxes ("EDIT") created by the corporate tax rate reduction included in the TCJA.

Taxpayer is a regulated public utility incorporated under the laws of State. Taxpayer is included in a consolidated U.S. Corporation Income Tax Return filed by an affiliated group of corporations of which Corporation is the common parent. Corporation is an investor-owned energy-based company incorporated under the laws of State and is the common parent of a consolidated group of corporations referred to as Consolidated Group. Consolidated Group files a federal consolidated tax return on a calendar year basis and use an accrual method of accounting.

Corporation is under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service (the "IRS" or the "Service").

Taxpayer generates electricity and provides electric transmission and distribution services throughout its service territory in State. Taxpayer also owns and operates a natural gas transmission, storage, and distribution system with a service territory which includes part of State.

Taxpayer's rates for electricity and natural gas utility services are subject to the jurisdiction of Commission A and Commission B. Both regulators set rates at levels that are intended to allow Taxpayer an opportunity to recover its costs of providing service, including a return on invested capital ("cost-of service, rate of return ratemaking").

Before setting rates, Commission A and Commission B conduct proceedings to determine the amounts that Taxpayer will be authorized to collect from its customers ("revenue requirements"). Taxpayer's base revenue requirements are established mainly in three different proceedings.

Taxpayer's electric transmission business is rate-regulated by Commission B through a transmission owner formula rate. Taxpayer's gas and electric distribution and electric generation businesses are rate-regulated by Commission A, typically in general rate case ("GRC") proceedings conducted every three years. Taxpayer's gas transmission and storage ("GT &S") businesses are also rate regulated in Commission A proceedings conducted every three or four years. In Year 1, Taxpayer expects that its GT &S rate proceedings will be merged into its GRC. This ruling request involves Commission A’s recent decisions in Taxpayer's Petition for Modification of its Year 2 GRC and its Year 3 GT &S rate cases (each a "PFM" and collectively "PFMs") to reflect revenue requirement reductions resulting from the corporate income tax rate reduction and other changes provided in the TCJA.

Taxpayer filed its PFMs on Date 1. The PFMs were filed to reflect revenue requirement reductions related to the tax changes included in the TCJA. Specifically, the PFMs covered several TCJA changes, but relevant to this request is the normalization methodology used to return EDIT to customers.

Prior to Year 4, Taxpayer computed timing differences between (i) book depreciation, including salvage value and cost of removal ("COR") expense, and (ii) tax deductions for tax depreciation and incurred COR. Taxpayer's tax depreciation exceeds its book depreciation in the early years of an asset's life and its book depreciation exceeds its tax depreciation in the later years of an asset's life. In contrast, Taxpayer's book COR expense precedes its tax deduction for COR because it books COR over the life of the asset and only receives a tax deduction when the COR is incurred at the end of the asset's life. These annual timing differences resulted in a net accumulated deferred income tax ("ADIT") liability at Date 2, based on the 35 percent corporate tax rate, which was in effect prior to the TCJA.

As a result of the corporate tax rate reduction provided by the TCJA, Taxpayer no longer expects to pay deferred taxes attributable to depreciation to the government or obtain a tax benefit when it incurs COR at the 35 percent rate at which these deferred tax amounts were accumulated. Rather, Taxpayer expects to pay those future taxes and receive those future tax benefits at the reduced 21 percent rate.

Taxpayer proposed to Commission A the normalization of these excess deferred taxes attributable to depreciation and COR over the remaining life of the underlying property. The excess tax reserve attributable to depreciation is reduced by multiplying- (i) the ratio of the aggregate deferred taxes for the assets to the aggregate timing differences for the assets as of the beginning of the period in which the depreciation timing differences begin to reverse, by (ii) the amount of the depreciation (not including COR) timing differences which reverse during the year. This computation reduces all deferred taxes, including excess deferred taxes, over the life of the property. The excess deferred tax asset attributable to COR is reduced ratably over the remaining life of the asset leaving a deferred tax debit at the end of asset's life equal to the product of the new tax rate and the COR. At the end of the asset's life, that balance (deferred tax asset) is removed from the deferred tax account to account for the realization of the tax benefit from the deduction of the COR at the end of the asset's life.

Commission A rendered its final decisions on Taxpayer's PFMs in Month Year 5. In its final decision, Commission A generally included the following in its order: Taxpayer's estimated revenue requirement reductions shall quantify the amount of unprotected excess ADIT, which can be returned to ratepayers without following ARAM; and Taxpayer's estimated revenue requirement reductions shall quantify the use of ARAM where it is required such that the COR is included in book depreciation when calculating the amount of protected excess ADIT which can be returned to ratepayers.

The primary difference between Commission A's position and Taxpayer's position is with respect to the treatment of COR in the ARAM calculation. Commission

B imposes certain accounting rules which are used by most large investor-owned electric and gas companies and are employed by Taxpayer. The applicable rules contain several definitions relevant to Taxpayer. Based on how these terms are defined, for purposes of regulatory (book) reporting, the net positive value or net cost of disposing of an asset at the end of its life is incorporated into the annual depreciation charge. Salvage value and COR are, therefore, components of establishing the applicable book depreciation rate. The combined rate (depreciation, salvage, and COR) is considered the Composite Rate that is approved by Commission A. Taxpayer did not account separately for COR and salvage value from depreciation prior to Year 4; thereafter Taxpayer tracked and continues to track its salvage and COR reserves separately from its accumulated depreciation reserve in its property-related deferred tax records.

In Taxpayer's case, due to the amount of COR it anticipates, in almost all instances its assets have negative net salvage values so that its composite book depreciation rates are higher than they would be were net salvage value not considered.

Taxpayer and Commission A agree that the DTL balance attributable to the accelerated tax depreciation deduction is protected by the Normalization Rules because it is attributable to the differences between tax and book depreciation. The DTA attributable to COR is not protected under the Normalization Rules because COR is not a tax depreciation deduction under § 168(k) of the Code, but rather a deduction under § 162. Nonetheless, Taxpayer normalizes the COR by providing customers with the tax benefit of COR over the life of the asset, which tax benefit Taxpayer will receive when it incurs COR at the end of the asset's life.

Commission A's position is that the COR component of book depreciation should be included in the annual timing difference used in the ARAM computation that Taxpayer uses to amortize EDIT, while Taxpayer contends that including the COR component of book depreciation in the annual timing difference used in the ARAM calculation accelerates the amortization of EDIT beyond that which is permissible under the Normalization Rules. There is no dispute between the parties on the determination of the EDIT or ADIT amounts for both depreciation and COR. The dispute is with respect to the amount of book depreciation [that is, whether COR is part of this amount] to which the average rate is applied under ARAM.

While the depreciation timing difference advocated by both Taxpayer and Commission A occurs over the remaining life of the asset, the inclusion of the additional depreciation advocated by Commission A, accelerates the period over which the original excess deferred tax liability is recovered (as illustrated in the example set forth in the ruling request, from a years to b years). The additional annual recovery under Commission A's position is attributable to the COR accrual treated as part of the depreciation-related deferred tax liability.

Commission A directed Taxpayer to comply with the IRS's interpretation of the applicable tax laws by filing with Commission A to seek an appropriate adjustment to its revenue requirement and/or rate base in the event that Taxpayer requests and receives a private letter ruling from the IRS or if the IRS issues specific guidance on this matter in any other form. See Decisions. Taxpayer is tracking the difference between its method and Commission A's method and expects Commission A will allow it to recover the acceleration of the protected deferred taxes over a period of up to two years, if the IRS concludes that Commission A's method is not a normalization method of accounting as required by the Normalization Rules. Commission A also ordered Taxpayer to request ruling number one, below, in the event Taxpayer requested a private letter ruling.

RULINGS REQUESTED

1. Is including COR/negative net salvage in the ARAM calculation for the return of EDIT attributable to depreciation to ratepayers inconsistent with normalization requirements? [This is the ruling request ordered by Commission A.]

2. Is the method proposed by Taxpayer consistent with the Normalization Rules?

3. If the Service rules that the method proposed by Commission A violates the Normalization Rules, Taxpayer's use of the method proposed by Commission A will not be a violation of the Normalization Rules, provided Commission A (i) approves the method proposed by Taxpayer (or otherwise required by the Service) and (ii) allows Taxpayer to recover any difference in the rates charged to customers under Commission A 's proposed method and the Taxpayer's method over a period that does not extend beyond the first two calendar years following the issuance of the Service's ruling.

LAW AND ANALYSIS

Normalization Rules in the Code and Regulations

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.

Uncodified Normalization Requirements in the TCJA

The TCJA, enacted on December 22, 2017, generally reduced the corporate tax rate under § 11 of the Code from 35 percent to 21 percent for taxable years beginning after December 31, 2017. Section 13001(a) of the TCJA.

Section 13001(d) of the TCJA includes accompanying but uncodified normalization requirements related to the reduction of the corporate tax rate.

Section 13001(d)(3)(A) of the TCJA defines the term “excess tax reserve”[1] to mean the excess of (i) the reserve for deferred taxes (as described in § 168(i)(9)(A)(ii) of the Code as of the day before the corporate rate reductions provided in the amendments made by this section take effect, over (ii) the amount which would be the balance in such reserve if the amount of such reserve were determined by assuming that the corporate rate reductions provided in this Act were in effect for all prior periods.

Section 13001(d)(3)(B) of the TCJA provides that the ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of

[1] While the TCJA refers to this excess amount as the excess tax reserve, the commonly used term and the term used throughout this ruling is EDIT.

the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the 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 which reverse during such period.

Section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of §§ 167 or 168 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 [EDIT] more rapidly or to a greater extent than such reserve would be reduced under the ARAM.

We note that Rev. Proc. 88-12, 1988-1 C.B. 637, provided similar rules after the Tax Reform Act of 1986 reduced the tax rate from 46 percent to 34 percent. Specifically, Rev. Proc. 88-12 stated that

> [f]or taxable years beginning on or after July 1, 1987, section 601 of the Tax Reform Act of 1986 (Act), 1986-3 (Vol. 1) C.B. 166, reduces from 46 percent to 34 percent the maximum federal income tax applicable to corporations. Section 203(e) of the Act provides rules for reducing the excess tax reserve resulting both from that reduction and from the smaller reduction in rates for tax years starting before and ending after (straddling) July 1, 1987. Section 203(e) of the Act provides that 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 Internal Revenue Code, f [*sic*] the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces its excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method.

Thus, because of the reduction in rates, for property subject to depreciation in a taxable year beginning on or before December 31, 2017, and not yet fully depreciated in the first taxable year beginning after December 31, 2017, a portion of the ADIT reserve will reflect this reduction. The portion of the ADIT reserve that reflects the difference in tax rates due to accelerated depreciation is referred to as EDIT. The EDIT represents the amount by which the ADIT reserve exceeds the amount it would have contained had the reduction in rates been in effect for every year the property was subject to depreciation. That is, the EDIT is the amount of accelerated depreciation-related taxes that have been collected from ratepayers but have not yet been paid by the utility and become excess due to the reduction in rates.

The Normalization Rules were enacted in response to Congressional concerns over the growing number of public utility commissions that were mandating investor-owned regulated utilities to not retain these tax benefits from accelerated depreciation, but, instead, to immediately flow-through all of these tax incentives to ratepayers in the form of lower income tax expense in regulated cost of service rates. Congress' response was to enact legislation that would preclude regulated investor-owned utilities from utilizing accelerated depreciation methods for tax purposes if the related tax benefits were immediately flowed-through to ratepayers in rates or were flowed-through to ratepayers faster than permitted under the Normalization Rules.

The underlying concept and purpose of the Normalization Rules is to prevent the flow-through of these accelerated depreciation-related tax benefits to ratepayers in regulated rates any faster than permitted by the Normalization Rules. Thus, the flow-through of these tax benefits to ratepayers faster than permitted by the Normalization Rules would result in a normalization violation that would preclude the taxpayer from using any of the accelerated tax depreciation methods on public utility property and, instead, require the taxpayer to use the same depreciation method and period as those used to compute depreciation expense in its cost of service for ratemaking purposes. Conversely, a taxpayer that flows through these tax benefits to ratepayers slower than permitted by the Normalization Rules, or that never flows through any of the tax benefits from accelerated depreciation to ratepayers, would not be in violation of those rules.

The Normalization Rules are intended to provide an allocation of the benefit from accelerated depreciation between a regulated public utility [Taxpayer] and its customers. This is accomplished by limiting the time and the manner in which Taxpayer is permitted to provide that benefit to its customers. In the typical case of tax depreciation deductions that are more accelerated than book depreciation expense, the Normalization Rules allow Taxpayer to postpone sharing the accelerated tax benefit in its cost of service over the period of time Taxpayer includes the depreciation expense of the asset in its cost of service.

Thus, the Normalization Rules provide the tax benefit of accelerated tax depreciation to Taxpayer as an interest free loan from the government, which is paid back to the government once the timing difference begins to reverse. Consistent with this characterization of the tax benefit of accelerated tax depreciation as an interest free loan, Taxpayer treats the amount as a reduction in rate base each year for the amount of the "loan" which remains outstanding. Thus, as long as the annual tax depreciation expense exceeds the annual book depreciation, Taxpayer’s customers pay an amount of tax expense that Taxpayer does not need to pay to the government in the current year but will pay in future years. Once the annual book depreciation expense begins to exceed the annual tax depreciation deduction the customers receive the tax benefit of the depreciation expense even though Taxpayer does not receive a current depreciation tax deduction. During the life of an asset, as long as accumulated tax depreciation exceeds accumulated book deprecation Taxpayer has an interest free loan from the government, which is represented by ADIT. Taxpayer treats this ADIT as a reduction in rate base, which reduces Taxpayer's allowed return on rate base and provides a benefit to customers, which is permissible under the Normalization Rules.

When the corporate tax rate is reduced as occurred with the TCJA, and part of the loan provided to the utility by the government through accelerated depreciation is forgiven, the general Normalization Rules of the Code no longer protect the EDIT. However, both in 1986 and 2017, Congress provided the additional Normalization Rules to quantify and protect the EDIT.

The difference between the reversal of EDIT and the regular deferred taxes is that the reduction of the regular deferred taxes offsets tax payable to the federal government while the reduction of EDIT is taken into account as a benefit in the computation of tax expense included in the cost of service for the year. In other words, the recapture of the prior excess tax benefit goes to customers instead of the federal government, but it does so over the same period of time and at the same rate as the regular deferred taxes recovered, and as all ADIT would be recovered in the absence of a corporate tax rate reduction. This provides the utility with the same benefit it anticipated at the time the asset was purchased and returns the excess of the benefit over the actual taxes paid to the government to the customers over the book life of the assets as part of the normal ratemaking process

When COR is normalized, which the Normalization Rules do not require, it results in a DTA, which is reversed when the COR is incurred at the end of the asset's life. The DTA attributable to COR represents an amount advanced by Taxpayer, which will not be recovered until the tax benefit from the COR is realized.

As described, section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the EDIT more rapidly or to a greater extent than such reserve would be reduced under the ARAM. ARAM is defined, in part, under section 13001(d)(3)(B) as the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property. Commission A’s method results in the recovery of EDIT over a shorter period than the remaining life of the property. Simply stated, the annual timing difference reversal provided in Commission A’s method is overstated by the COR which is not included in the aggregate timing differences for the property at the beginning of the year. Rather than only establishing a new deferred tax asset for a new COR accrued for books, the new COR also is used to accelerate the recovery of the EDIT. This violates the Normalization Rules in section 13001 of the TCJA. In contrast, Taxpayer’s proposed method is consistent with the Normalization Rules.

While COR is taken into account as an element of book composite depreciation, COR does not produce a timing difference that represents the type of timing difference that is protected by the normalization rules. The COR portion in book composite depreciation represents a timing difference that will reverse when the tax benefit is realized at the time the COR is incurred. ARAM controls the return of tax expense collected from customers for which Taxpayer already has received an accelerated tax benefit, which tax benefit will not be repaid to the government as a result of the corporate rate reduction. While Taxpayer included the tax benefit of COR in cost of service, Taxpayer receives no tax benefit from the government for COR until the asset is removed from service. Any accumulated excess deferred tax asset attributable to COR represents deferred tax benefits Taxpayer has provided to customers at the 35 percent corporate tax rate, which now are expected to produce only a 21 percent current tax benefit for Taxpayer when realized as a result of the corporate tax rate reduction. While the method by which Taxpayer is permitted to recover this excess deferred tax benefit that it already has provided to customers is not governed by the Normalization Rules, those Normalization Rules do not contemplate COR timing differences accelerating the return of EDIT to customers, which is protected under the Normalization Rules.

Section 4.01(6) of Rev. Proc. 2020-39, 2020-36 I.R.B. 546, provided transition rules due to the reality that many utilities had already been required to adjust rates due to the TCJA. According to this provision in Rev. Proc. 2020-39, "[u]tilities may correct any method of reversing ETR [EDIT] that is not in accord with this revenue procedure at the next available opportunity. The methods adopted prior to the publication of this revenue procedure that are not in accord with this revenue procedure are not considered to be a violation of the normalization rules if so corrected. This corrective action will require the utility to consult with its regulator and obtain its regulator's consent. Utilities are not in conflict with section 13001(d) of the TCJA if the utilities follow such a path to correct potential normalization violations prospectively. These rules extend to companies that may not have started the amortization of ETRs [EDIT] or may be re-deferring the amortization as they evaluate their records."

Additionally, § 168(f)(2) itself 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. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Commission A has not required or insisted upon treatment by Taxpayer that it knows is noncompliant with the Normalization Rules. Further, Commission A has directed Taxpayer to comply with the IRS's interpretation of the applicable tax laws by filing with Commission A to seek an appropriate adjustment to its revenue requirement and/or rate base in the event that Taxpayer requests and receives a private letter ruling from the IRS or the IRS issues specific guidance on this matter in any other form. Taxpayer also intended at all times to comply with the Normalization Rules. Taxpayer has initiated the measures necessary to conform to the Normalization Rules. Taxpayer is tracking the difference between its method and Commission A's method and expects Commission A will allow it to recover the acceleration of the protected deferred taxes over a period of up to two years, if the IRS concludes that Commission A's method is not a normalization method of accounting as required by the Normalization Rules.

Taxpayer's failure to comply with the Normalization Rules was inadvertent. Because the Commission, as well as Taxpayer, at all times sought to comply, and because corrective actions will be taken at the earliest available opportunity, it is not appropriate to conclude Taxpayer's use of the method proposed by Commission A constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

CONCLUSION

Based on the foregoing, we conclude as follows:

1. Including COR in the ARAM calculation for the return of EDIT attributable to depreciation to ratepayers is inconsistent with normalization requirements.

2. The method proposed by Taxpayer is consistent with the Normalization Rules.

3. As stated in Conclusion 1, the method proposed by Commission A is inconsistent with the Normalization Rules. However, Taxpayer's use of the method proposed by Commission A will not be a violation of the Normalization Rules, provided Commission A (i) approves the method proposed by Taxpayer (or otherwise required by the Service) and (ii) allows Taxpayer to recover any difference in the rates charged to customers under Commission A's proposed method and the Taxpayer's method over a period that does not extend beyond the first two calendar years following the issuance of the Service's ruling.

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 & Special Industries)

Enclosure:
Copy for § 6110 purposes

cc:

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