REV-RUL, Depreciation; public utility., Rev. Rul. 83-37, 1983-1 CB 60, (Jan. 01, 1983)

Rev. Rul. 83-37, 1983-1 CB 60

Section 167.--Depreciation

26 CFR 1.167(l)-1: Limitations on reasonable allowance in case of property of certain public utilities.

[IRS Headnote] Depreciation; public utility.--
A public utility taxpayer will not be denied the use of accelerated methods of depreciation when it prospectively normalizes all differences between book and tax accounting (full normalization) in compliance with a Federal Energy Regulatory Commission (FERC) order. Furthermore, the taxpayer will not be in violation of section 167(1), even if it is normalizing with respect to property previously flowed through to the ratepayers, when the balance in its deferred tax account equals or exceeds the historical amount determined by the book and tax differences directly addressed by section 167(1).

[Text]

ISSUE

Will a public utility taxpayer be denied the use of accelerated methods of depreciation if it complies with an order of the Federal Energy Regulatory Commission (FERC) to normalize all tax differences between book and tax accounting for depreciation, including differences attributable to property for which flow-through accounting was previously used?

FACTS

In 1967, the taxpayer, a regulated public utility, began flowing through to ratepayers all tax deferrals resulting from the differences between book and tax accounting, including those attributable to the use of accelerated depreciation for federal income tax purposes while using straight line depreciation for book purposes. This method of flowing through all book-tax differences continued through 1974. In 1975 the taxpayer properly changed its accounting method to normalize prospectively, under the provisions of section 167(l) of the Internal Revenue Code for all qualified property.

In 1977, FERC issued an order for ratemaking purposes requiring the use of the "Comprehensive Interperiod Allocation of Income Taxes" method of normalization, [hereinafter referred to as the FERC Comprehensive Full Normalization Method] as described below.

This FERC Comprehensive Full Normalization Method was designed to normalize all tax differences attributable to the use of different accounting methods for book and tax purposes in 1977 and subsequent years. Under this procedure, the federal tax expense used to determine cost of service for ratemaking purposes and for reflecting operating results in the taxpayer's regulated books of account is computed by using the same accounting methods used to compute depreciation expense for ratemaking purposes. Therefore, in computing tax expense for ratemaking purposes, items such as interest, taxes, etc., are capitalized rather than deducted as current expense; and a depreciation deduction equal to the taxpayer's depreciation expense for ratemaking purposes (determined by using a depreciable basis that included capitalized expenses such as interest, taxes, etc.) and a depreciation rate based on the use of a straight line depreciation method and useful lives equal to book lives are used.

Because the FERC Comprehensive Full Normalization Method applies to property placed in service before 1977, when some or all book-tax differences had been flowed through to ratepayers, it also requires an annual addback to the cost of service, which is designed to generally offset the effect of normalizing with respect to property previously accounted for under a flow-through method. This annual addback is computed as follows:

(1) The remaining tax basis of all the taxpayer's plant is subtracted from the remaining book basis of such plant at the time the FERC Comprehensive Full Normalization Method is adopted.

(2) The amounts added to the deferred tax reserve before 1977 are divided by the tax rates for the years in which such additions were made to the reserve.

(3) To compute the amount of deductions previously flowed through to ratepayers, the amounts arrived at in step (2) are subtracted from the amount arrived at in step (1).

(4) The amount of previously flowed through deductions computed in step (3) is then allocated to 1977 and later years by dividing such amount by the approximate remaining book life (in years) of all plant then in service.

(5) For each of the years to which an amount is allocated in step (4), the tax attributable to the allocated amount is included as an additional tax expense; thereby, the amounts to be added to the deferred tax reserve in such years areincreased.

LAW AND ANALYSIS

For public utility property placed in service before January 1, 1970, section 167(l)(1) of the Code dictates that, if the taxpayer has been using accelerated depreciation and has been normalizing its deferred taxes, it can continue to use accelerated depreciation only if it continues to normalize with respect to that property. If the taxpayer has been using accelerated depreciation and flowing through to its ratepayers the benefits of the tax deferral, it is required to continue to do so with respect to that property unless the appropriate regulatory agency permits it to change. For property placed in service after December 31, 1969, section 167(l)(2) provides that if the taxpayer has been using a flow-through method with respect to its pre-1970 property of the same (or similar) kind most recently placed in service, it should continue to use accelerated depreciation and flow-through unless the regulatory agency permits it to change. In all other cases, the taxpayer may use accelerated depreciation only if it normalizes the deferred income taxes.

Section 167(l)(3)(G) of the Code and section 1.167(l)-1(h)(1)(i) of the Income Tax Regulations specify that to qualify as using a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results on its regulated books of account; and if the taxpayer uses a different method for purposes of claiming depreciation on its tax return, it must make adjustments to a reserve to reflect the total amount of federal income tax deferral resulting from the use of such different methods of depreciation with respect to all its public utility property (other than property for which flow-through accounting is used).

Section 1.167(l)-1(h)(1)(i)(*b*) of the regulations requires the taxpayer who normalizes to make adjustments to its deferred tax reserve to reflect the total deferral of federal income tax liability with respect to all its public utility property (other than property for which flow-through accounting is being used) resulting from its use for tax purposes of a different method of depreciation than it uses for ratemaking and book purposes. Section 1.167(l)-1(h)(1)(iii) specifies that the amount of federal income tax deferred is the excess of the amount the tax liability would have been had a subsection (l) method (generally, a straight line method) been used over the amount of the actual tax liability.

The FERC Comprehensive Full Normalization Method requires that adjustments to a deferred tax reserve be made for the effects of all book-tax differences, not simply those differences for which adjustments are required by the section 167(l) regulations. Furthermore, this method provides for normalization with respect to all the taxpayer's public utility property, including property that had previously been accounted for unde a flow-through method.

Section 1.167(l)-1(a)(1) of the regulations specifically states that the section 167(l) 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. Thus, the requirement of the FERC Comprehensive Full Normalization Method for normalization of book-tax timing differences other than those covered by section 167(l) of the Code has no bearing upon whether the method satisfies the requirements of section 167(l) and the regulations thereunder. Furthermore, because the amount of deferral attributable to nonsection 167(l) differences is unrelated to the amount of deferral caused by section 167(l) differences and because full normalization, *i.e.,* the normalization of all book-tax timing differences, necessarily includes the normalization of those book-tax differences addressed by section 167(l), and use of the FERC Comprehensive Full Normalization Method with respect to public utility property placed in service after such normalization method is adopted does not result in violation of section 167(l).

However, the FERC Comprehensive Full Normalization Method goes beyond requiring prospective full normalization of all book-tax timing differences. It requires taxpayers to normalize not only book-tax differences for assets placed in service after the adoption of such method but also for assets placed in service when normalization was not required or when normalization of only some book-tax timing differences was required.

The FERC Comprehensive Full Normalization Method does not compute the amount of federal tax deferral with respect to any particular asset or class of assets, as would normally be done in computing under section 1.167(l)-1(h)(1)(i) of theregulations the amount of federal income tax deferral. Rather, it focuses on the total plant investment. By computing the annual additions to the deferred tax reserve on the basis of the annual aggregate differences between book and tax depreciation for the entire plant, full normalization with respect to property concerning which flow-through accounting has previously been used allows current deductions to the deferred tax reserve with respect to property for which book depreciation now exceeds tax depreciation even though no amounts were added to the reserve when tax depreciation was higher than book depreciation because such differences were flowed through to ratepayers. However, the method attempts to counter the effectsof having flowed through prior book-tax differences rather than having normalized them by providing for the addback, which increases the tax expense for ratemaking purposes during the remaining book life of all the taxpayer's plant.

Were it not for addback, it is apparent that the annual adjustments would cause the deferred tax account balance to be reduced in violation of section 1.167(l)-1(h)(2)(i) of the regulations (unless additions to the account with respect to nonsection 167(l) book-tax differences made up for this deficit). However, if the previously flowed through amounts were added back at a rate assuring that sufficient amounts were added annually to counteract the effect of normalizing for property for which benefits had been previously flowed through, the FERC Comprehensive Full Normalization Method would be acceptable, since the annual additions to the deferred tax account would equal on a composite basis the amount required by section 167(l) of the Code and the amount needed to normalize all other book-tax timing differences. But the period for amortizing the addback is the average remaining useful life of the entire plant while the period for which differences must be accounted for under Section 1.167(l)-1(h)(1) of the regulations will normally differ depending upon the type and vintage year of the particular assets for which accelerated depreciation has been claimed. Because of this, the FERC Comprehensive FullNormalization does not assure that the addback period will properly correlate to the period for which adjustments are required under section 167(l).

If the addback in a given year for previously flowed-through amounts were too low, the addition to the deferred tax account for that year with respect to section 167(l) differences would be less than the required amount. This would cause a reduction of the deferred tax account for reasons other than those specified in section 1.167(l)-1(h)(2)(i) of the regulations and, because of this violation of section 167(l), the taxpayer would lose the right to use accelerated depreciation.

Therefore, to assure that section 167(l) of the Code is not violated in a particular case by the use of the FERC Comprehensive Full Normalization Method, a taxpayer who previously used flow-through accounting must compute, during each year in which an addback is required, the minimum addition required by section 167(l). This is done by calculating for each public utility property the difference between accelerated depreciation taken on the taxpayer's return and the amount that would have been taken as depreciation if the taxpayer had used a straight line method instead. The amount that would have been taken as straight line depreciation should be computed by reference to the tax basis, not the book basis, of the property at the time that normalization was adopted with respect to the property. For each year in which an addback is required, the balance in the deferred tax reserve must equal or exceed the amount that would have been in the account if only book-tax differences addressed by section 167(l) had been normalized.

HOLDING

The public utility taxpayer will not be denied the use of accelerated methods of depreciation when it complies with an order from FERC to prospectively normalize all differences between book and tax accounting (full normalization) ratherthan only the difference between accelerated and straight line depreciation. However, if a taxpayer is normalizing with respect to property previously accounted for under a flow-through method, the taxpayer will meet the requirements of section167(l) of the Code if the balance in its deferred tax account equals or exceeds the amount that would have been in the account if only book-tax differences addressed by section 167(l) had been normalized.