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January 27, 2014

LEGEND:

Taxpayer =

Parent =

State =
Commission =
Year A =
Year B =
Year C =
Year D =
Year E =
X =
Y =
Date A =
Date B =
Date C =
Date D =
Date E =
Case =
Director =

Dear . :

This letter responds to the request, dated July 30, 2013, of Taxpayer for a ruling on whether the Commission's treatment of Taxpayer's Accumulated Deferred Income

Tax (ADIT) account balance in the context of a rate case is consistent with the requirements of the normalization provisions of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State. It is wholly owned by Parent. Taxpayer distributes and sells natural gas to customers in State. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer takes accelerated depreciation where available and, for the period beginning in Year A and ending in Year E, Taxpayer has, in the aggregate, produced more net operating losses (NOL) than taxable income. After application of the carryback and carryforward rules, Taxpayer represents that it has net operating loss carryforward (NOLC), produced in Year C and Year E, of $X as of the end of Year E. The amount of claimed accelerated depreciation in Year C and Year E exceeded the amount of the NOLCs for those years. In Year D, Taxpayer produced regular taxable income as well as alternative minimum taxable income (AMTI); the regular taxable income was offset by the NOLCs from Year B and year C but could not offset the entire alternative minimum tax (AMT) liability due to the limitation in § 56(d). Taxpayer paid $Y of AMT in Year D and had a minimum tax credit carryforward (MTCC) as of the end of year E of $Y.

On its regulatory books of account, Taxpayer “normalizes” the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute “cost-free capital” to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account and also maintains an offsetting series of entries that reflect that portion of those ‘tax losses’ which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC. With respect to the $Y AMT liability from Year D, Taxpayer carried that amount as an offset to the ADIT because the AMT increased the payment of tax.

Taxpayer filed a general rate case on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In establishing the income tax expense element of its cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission generally offsets rate base by Taxpayer’s plant based ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of

NOLCs or the AMT. Commission, in an order issued on Date C, did not use the amounts that Taxpayer calculates did not defer tax due to NOLCs or AMT but only the amount in the ADIT account. Taxpayer filed a petition for reconsideration based on the normalization implications of the order. On Date D, Commission rejected Taxpayer's request. Taxpayer again requested reconsideration and the Commission denied that request on Date E. Commission asserts that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has, such as in this case, an NOLC or AMT. Thus, Commission asserts that it has already recognized the effects of the NOCL in setting rates and there is no need to reduce the ADIT by the other amounts due to NOLCs or AMT.

Taxpayer requests that we rule as follows:

Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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 section 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 section 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 section 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 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax 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 section 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(1)-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 (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss 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 section 167(a) using a subsection (1) 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 section 167(1) 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 section 1.167(1)-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 section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 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(1)-(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), 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 section 1.167(1)-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.

Section 55 of the Code imposes an alternative minimum tax on certain taxpayers, including corporations. Adjustments in computing alternative minimum taxable income are provided in § 56. Section 56(a)(1) provides for the treatment of depreciation in computing alternative minimum taxable income. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 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. Taxpayer has done so. Section 1.167(1)-(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 56(a)(1)(D) provides

that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In the rate case at issue, Commission has excluded from the base to which the Taxpayer's rate of return is applied the reserve for deferred taxes, unmodified by the accounts which Taxpayer has designed to calculate the effects of the NOLCs and MTCC. There is little guidance on exactly how an NOLC or MTCC must be taken into account in calculating the reserve for deferred taxes under §§ 1.167(1)-1(h)(1)(iii) and 56(a)(1)(D). However, it is clear that both must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT) for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, while we accept as true for purposes of this ruling Commission's assertions that it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or AMT, we do not conclude that it has done so and those assertions are subject to verification on audit.

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:

Deloitte.

Determining whether a utility's ratemaking treatment of an NOL carryforward complies with the normalization requirements

Situation presented

Many utilities have incurred net operating losses (NOLs) in recent years due to bonus depreciation, favorable section 481(a) adjustments, or general economic conditions. The proper treatment of the resulting NOL carryforward under the normalization requirements has been the subject of numerous ratemaking proceedings.

On May 2, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling (PLR) 201418024 regarding the treatment of deferred tax assets (DTAs) for NOL carryforwards under the deferred tax normalization requirements of Treas. Reg. § 1.167(1)-1(h)(1)(iii). PLR 201418024 held that not including the NOL carryforward DTA in rate base, the methodology advocated by the public utility commission, complied with the normalization requirements in a specific circumstance.

On September 5, 2014, the IRS released PLR 201436037 and PLR 201436038, holding that failure to take into account the portion of an NOL carryforward that is attributable to accelerated depreciation in calculating the amount of a deferred tax liability (DTL) in the computation of rate base would be inconsistent with the normalization requirements and further, that any method for determining the portion of the NOL carryforward attributable to accelerated depreciation other than the "with and without" method would be inconsistent with the normalization requirements. On September 19, 2014, the IRS released PLR 201438003 providing guidance consistent with the other two rulings issued in September. The methodologies held to comply with the normalization requirements in the more recent rulings were the methodologies advocated by the utilities.

Issue

The methodology that was held to comply with the normalization requirements in PLR 201418024 results in a lower revenue requirement than (1) the alternatives advocated by and approved for many utilities in their rate cases and (2) the approaches held to comply with the normalization requirements in the limited number of NOL-related PLRs released in prior years. This ruling may create regulatory risk in pending and future rate cases for other utilities with NOL carryforwards.

Utilities may need to demonstrate that the rationale underlying the methodology in PLR 201418024 is inapplicable in their factual situations if not universally arguing that it simply is an inappropriate manner of analyzing the recovery of regulatory tax expense, notwithstanding the holdings of the recent three rulings

that did not indicate that the factors or rationale of PLR 201418024 are relevant in applying the normalization requirements for NOL carryforwards.

Background

Treas. Reg. § 1.167(1)-1(h)(1)(iii) provides that if an NOL carryforward would not have arisen (or increased), but for the use of accelerated tax depreciation, 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. This rule recognizes that depreciation-related DTLs are interest-free loans from the government extended via the reduction of current tax liability due to the use of accelerated tax depreciation, and should not reduce the rate base (or, depending on the ratemaking mechanics used by the regulator, reduce the weighted-average cost of capital) unless the depreciation-related DTLs result in a reduction of cash taxes (i.e., serve as a source of funding). This tax rule is consistent with the economics of ratemaking, but is not as prescriptive as most of the deferred tax normalization requirements and does not provide examples of specific methodologies that comply with or violate the rules. Instead, the rule effectively directs utilities to obtain private letter rulings to determine whether their public utility commissions' ratemaking treatments of depreciation-related DTLs, while in an NOL carryforward position, comply with the normalization requirements.

Prior to the 2014 ruling, the IRS had issued one PLR regarding the application of the normalization rules to NOL carryforwards and two PLRs regarding the application of the normalization rules to NOL carrybacks. The three rulings addressed fact patterns involving carryovers to tax years with different statutory tax rates than the tax rates in effect in the years the NOLs were generated, a dynamic not present in rate cases in recent years.

In PLR 8818040, the IRS held that the regulations provide that the amount of deferred taxes subject to the normalization rules in a year an NOL is generated is computed using a "with-and-without" methodology (i.e., deferred taxes equal the excess of taxes due without accelerated depreciation over the taxes due with accelerated depreciation) and using the tax rate effective for the year the tax deferral is realized. The net effect of this accounting in the NOL years was to record no deferred taxes applicable to the amount of accelerated depreciation that produced no current tax savings (i.e., that caused or increased the NOL carryforward). The IRS further ruled that the DTL should not be recorded for ratemaking purposes until 1987, the year in which the utility benefitted from the NOL attributable to accelerated depreciation, and at the tax rate effective for 1987 (i.e., 39.95 % rather than the 46% tax rate effective for 1985 and 1986, the years the NOLs were generated). The taxpayers did not request guidance on alternative methodologies and the ruling did not address the proration methodology that was analyzed in the 1989 and 1993 rulings summarized below.

In PLR 8903080, the utility incurred an NOL in a tax year with a tax rate of 39.95%, estimated for ratemaking purposes that it would incur an NOL in a tax year with a 34% rate and carried back the NOLs to tax years with tax rates of 46% for purposes of determining ratemaking deferred taxes. For each NOL year, the utility recorded a total tax provision (i.e., sum of the current and deferred tax provisions) at the tax rate in effect for the year in which each NOL was generated (i.e., 39.95% or 34%, respectively). The current tax benefits of the years the NOLs were generated were measured at the 46% tax rates applicable to the years to which the NOL carrybacks were deducted. In each year an NOL was generated, the deferred tax expense attributable to the book-tax timing differences was recorded at a tax rate in excess of the statutory tax rates in effect for the years the NOLs were generated (as well as in excess of the enacted tax rates of the future tax years when the timing differences were expected to reverse). The tax rate differential as a result of the NOL carrybacks to the higher rate tax year was allocated pro rata to all timing items for the years the NOLs were generated. The IRS held that recording a total tax provision at the current year's statutory tax rate for each year an NOL was generated is appropriate and is consistent with the normalization requirements of Treas. Reg. § 1.167(1)-1(h)(1)(iii). This ruling also indicated that the methodology complied with the normalization requirements applicable to excess deferred income taxes under section 203(e) of the Tax Reform Act of 1986. The methodology described above was the only approach analyzed in the ruling.

In PLR 9336010, the utility incurred an NOL in a tax year with a 34% tax rate and carried back the loss to a year with a 46% tax rate. For financial reporting purposes, the utility recorded deferred taxes for all timing differences originating in the year the NOL was generated at the 34% tax rate applicable to such year (and future years). Commission staff recommended that for ratemaking purposes deferred taxes be recorded at the 46% tax rate applicable in the carryback years and that an excess DTL reducing rate base be created. The commission adopted the staff's recommendation and ordered the utility to seek a private letter ruling to determine the amortization method and period related to the excess tax reserve resulting from the interaction of the reduction in corporate

income tax rates and the NOL carryback. The utility and commission staff asserted that none of the excess tax reserve resulting from the NOL carryback resulted from the use of accelerated depreciation. The IRS disagreed and concluded that the taxpayer had not shown which particular items caused the NOL and, thus, the appropriate methodology to allocate the excess tax reserve among timing differences originating in the year the NOL was generated is a pro rata allocation to all timing differences. The IRS held that a portion of the excess deferred tax reserve resulting from the NOL carryback is attributable to the timing difference for accelerated depreciation and that only this portion of the excess tax reserve is subject to the normalization requirements for excess deferred taxes. There was no detailed discussion on exactly how the pro rata allocation was to be effectuated by the taxpayer in this ruling.

The taxpayer in PLR 201418024 incurred taxable losses in excess of taxable income over a multiyear period and as of its test year had an NOL carryforward and a minimum tax credit (MTC) carryforward (attributable to the rule limiting utilization of alternative minimum tax NOL carryforwards to 90% of alternative minimum taxable income). The amount of accelerated depreciation claimed in the two loss years exceeded the amount of NOLs incurred in those years. The utility filed a general rate case with plant-based DTL balances reduced by the amounts of tax not deferred due to the NOL and MTC carryforwards. The commission issued an order with rates based on DTL balances unreduced by the effects of the carryforwards. In its analysis, the IRS stated that there is little guidance on exactly how an NOL or MTC carryforward must be taken into account in calculating DTLs pursuant to the normalization requirements, but it is clear that both must be taken into account for ratemaking purposes. The ruling indicates that the commission has stated that in setting rates it included a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility had an NOL or MTC carryforward. This approach is described as allowing a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOL and MTC carryforwards. The IRS accepted these commission assertions as true for purposes of the ruling, did not conclude that the commission had actually set rates in accordance with the assertions, and indicated that the assertions are subject to verification on audit. The IRS held that reduction of rate base by the full amount of the DTL account without regard to the balances of the NOL and MTC carryforward accounts was consistent with the normalization requirements because the commission already took the carryforwards into account in setting rates.

The taxpayer and its consolidated group in PLR 201436037 incurred or expected to incur NOLs resulting in NOL carryforwards. The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward. Other approaches were proposed by other rate case participants, including a proposal to reduce regulatory tax expense by the amount of the DTA determined to be attributable to accelerated depreciation. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements. Further, any reduction to tax expense included in cost of service to reflect the tax benefit of an NOL carryforward would be inconsistent with the normalization requirements because such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to ratepayers even though the taxpayer had yet to realize the benefits.

Similarly, the taxpayer and its consolidated group in PLR 201436038 incurred or expected to incur NOLs resulting in NOL carryforwards. The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward. Other approaches were proposed by other rate case participants. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that

the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements.

The utility subsidiary in PLR 201438003 forecasted that it would incur an NOL resulting in an NOL carryforward in its test period. The utility reduced its DTL used to reduce rate base by the amount of the DTA for the NOL carryforward. The utility's commission issued an order holding that it was inappropriate to include the DTA for the NOL carryforward in rate base, but stating that it intended to comply with the normalization requirements and that it would allow the utility to seek an adjustment to rates if it obtains a private letter ruling affirming the utility's position that failure to reduce its rate base offset for depreciation-related DTL by the DTA attributable to the NOL carryforward would be inconsistent with the normalization requirements. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology employed by the utility provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balance unreduced by the balance of the DTA for the NOL carryforward would be inconsistent with the normalization requirements. The IRS also ruled that use of a balance for the portion of the DTA for the NOL carryforward attributable to accelerated depreciation that is less than the amount computed on a with-and-without basis would be inconsistent with the normalization requirements. The IRS also held that assignment of a zero rate of return to the balance of the DTA for the NOL carryforward attributable to accelerated depreciation would be inconsistent with the normalization requirements.

Implications

The economic and regulatory debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking involves acknowledgment that recorded DTLs resulting from enacted tax incentives, such as accelerated depreciation intended to stimulate the economy, essentially represent interest-free loans from the government to taxpayers, regardless of the industry of the taxpayer or how the taxpayer sets its prices. The interest-free loan only occurs if or to the extent the corresponding deductions result in reduction (deferral) of tax payments to the government. This does not occur when the deductions for accelerated depreciation result in or contribute to an NOL carryforward.

The normalization debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking may involve:

- Whether the full amount of the depreciation-related DTL may reduce rate base despite the existence of an NOL carryforward (i.e., whether the DTA for the portion of an NOL carryforward attributable to accelerated depreciation must be included in rate base);
- How to compute the depreciation-related portion of a DTA for an NOL carryforward; and
- Consideration of alternative approaches to reduce the revenue requirement when an NOL carryforward exists and some or all of the DTA for the NOL carryforward is included in rate base.

The IRS has exercised the discretion granted to it by the normalization regulations to assess whether the specific methodologies arising in rate cases and presented in five private letter ruling requests involving NOL carryforwards comply with the normalization requirements. The alternatives and arguments of the parties to the rate proceedings have varied in the private letter rulings issued in this area.

In PLR 201418024, the only private letter ruling on these matters resulting from a ruling request that did not seek guidance regarding use of the with-or-without methodology, the IRS instead considered a perspective presented that focused on whether the utility had recovered through rates charged amounts that compensated it for deferred tax expense attributable to depreciation deductions that had not yet resulted in savings of cash taxes in the current year or a carryback year. Whether this factor is relevant is questionable and how to determine whether this condition exists is challenging. Without explaining how to determine whether this ratemaking condition exists, the IRS held in PLR 201418024 that there is a ratemaking approach that

complies with the deferred tax normalization requirements yet permits not reducing depreciation-related DTLs due to the existence of an NOL or MTC carryforward.

In light of the analysis and holding of PLR 201418024, utilities may need to evaluate whether they have recovered depreciation-related deferred tax expense from ratepayers when NOL carryforwards have been incurred or are expected to recover depreciation-related deferred taxes from ratepayers when NOL carryforwards are forecasted. Utilities without tax adjustment clauses (i.e., "trackers") or without true-up mechanisms with regard to allowed earnings may have difficulty establishing whether or not they have actually recovered the amount of income taxes inherent in their revenue requirement or the portions of their actual revenues attributable to regulatory income tax expense. Any such analysis should also address whether it is possible or appropriate to evaluate whether a single component of regulatory tax expense (i.e., depreciation-related deferred tax expense) has been recovered through rates without regard to the other components of the tax provision (e.g., other components of the deferred tax provision, the current tax provision, investment tax credit (ITC) amortization). In analyzing the application of the facts and assumptions of PLR 201418024 to their rate situations, utilities will likely need to assess whether the income tax components of their revenue requirements in their most recent rate cases (or their actual revenues during the years NOLs were generated) are determined with reference to allowed equity returns, actual equity returns, book-tax differences, or other factors. It would also be worthy to note whether the depreciation-related portion of deferred tax expense exceeds the total or net tax provision (in light of the current tax benefit likely recorded in an NOL year).

The factor analyzed in PLR 201418024 was not mentioned in the other four NOL carryforward normalization letter rulings. In the other four private letter rulings, the IRS consistently held that the maximum depreciation-related DTL that is allowed to reduce rate base must consider the existence of an NOL carryforward and that the depreciation-related portion of the DTA for the NOL carryforward included in rate base must be computed with reference to a with-or-without approach (sometimes referred to as a with-and-without approach in the rulings).

The IRS has also ruled that two alternative approaches proposed by parties to rate proceedings seeking to reduce revenue requirements when an NOL carryforward exists would violate the normalization requirements. These alternatives were proposed to mitigate or eliminate the effect of inclusion of a DTA related to an NOL carryforward in rate base reduction of recoverable tax expense by an amount equal to the deferred tax benefit associated with the DTA, and treatment of the DTA as zero-cost capital. Utilities should continue to assert economic, ratemaking, and tax normalization defenses against similar assertions that aim to circumvent the effects of the normalization requirements.

Lastly, it should be noted that there are a number of other pending ruling requests regarding the application of the normalization requirements to NOL carryforwards that will afford the IRS additional opportunities to provide guidance on this important issue.

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