BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Services to Continue the Implementation of Its Regulatory Plan	))))))	Case No. ER-2010-0355
In the Matter of the Application of KCP&L Greater Missouri Operations Company for Approval to Make Certain Changes in its Charges For Electric Service	)))))	Case No. ER-2010-0356

BRIEF OF KANSAS CITY POWER & LIGHT CO. AND KCP&L GREATER MISSOURI OPERATIONS CO. ON THE ADVANCED COAL TAX CREDIT ISSUE

Kansas City Power & Light Company ("KCP&L") and KCP&L Greater Missouri Operations Company ("GMO") provide the following argument, as well as proposed findings of fact and conclusions of law, regarding the advanced coal tax credit issue, pursuant to the Commission's Order of February 24, 2011:

I. Argument.

There are complex questions of fact and law relating to KCP&L's application for Section 48A advanced coal tax credits that were created by the Energy Policy Act of 2005, and the 2008 award of $125 million of such credits to KCP&L by the Internal Revenue Service ("IRS"). However, there is one overriding and absolutely critical point that must not be lost: Whatever the Commission does with regard to this issue, it must not create a normalization violation that could cost both KCP&L and GMO, as well as their customers over $134 million.

KCP&L believes that it acted diligently and prudently when it applied in October 2007 for advanced coal credits that were available under federal law for a qualifying advanced coal facility like Iatan 2. After the IRS awarded KCP&L $125 million of tax credits in April 2008 for

the Iatan 2 project because it was the only utility that submitted a timely application regarding Iatan 2, three of the Iatan co-owners objected. The Empire District Electric Company ("Empire"), the Missouri Joint Municipal Electric Utility Commission ("MJMEUC") and Kansas Electric Power Cooperative, Inc. ("KEPCo") initiated an arbitration proceeding pursuant to the Iatan Unit 2 and Common Facilities Ownership Agreement ("Iatan 2 Agreement"). In the Final Arbitration Award issued on December 30, 2009, Empire won its claim, while MJMEUC and KEPCo lost. See Sched. 1 (HC), Staff Witness Harrison Surrebuttal.

Pursuant to that award and the arbitrators' order, KCP&L and Empire approached the IRS to amend the August 26, 2008 Memorandum of Understanding ("MOU") between KCP&L and the IRS which confirmed the allocation of $125 million in Section 48A advanced coal credits to KCP&L for Iatan 2. That MOU was modified and superseded by a second MOU, received by KCP&L on September 9, 2010, which avoided a normalization violation by reallocating the tax credit so that KCP&L received $107,287,500 and Empire received $17,712,500. See Sched. 3 at pp. 5-9 (HC), Harrison Surrebuttal.

If the Commission believes that a further allocation should occur so that GMO, as a co-owner of Iatan 2, receives a proportionate share of these tax credits according to its ownership interest, the Commission should order KCP&L and GMO to seek a further amendment of the MOU with the IRS under which KCP&L now holds the tax credits.

A. Normalization Violations Can Cause the Loss of Tax Credits and Compel Repayments to the IRS.

Both Melissa Hardesty, KCP&L's Director of Tax, and Staff witness Paul R. Harrison agreed that normalization violations can result in the loss of tax credits and trigger repayments to the IRS if a state utility commission attempts to reallocate tax credits among regulated public utilities. Tr. 3936-37 (Hardesty), 3961-67 (Harrison). As stated in Private Letter Ruling

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("PLR") No. 200945006 (Nov. 6, 2009): "If a normalization violation occurs, the results under [the tax laws] would be the disallowance or recapture of all of the unamortized investment tax credit of Taxpayer with respect to public utility property." See Ex. 106 at p. 3. Additionally, under Section 211(b) of the Tax Reform Act of 1986, "all credits for tax years open under the statute of limitations at the time a final determination is rendered [by a state utility regulatory commission] inconsistent with normalization requirements are recaptured." Id. at 7.

The facts in this 2009 PLR involved the natural gas assets of a public utility that were transferred to another public utility. The regulatory commission in question sought to require the seller to transfer to the buyer the balance of its then-existing accumulated deferred investment tax credit. The IRS concluded in the PLR that if the action requested by the regulatory commission were carried out, a normalization violation would occur and "the result under former Section 46(f)(4) would be the disallowance or recapture of all of the unamortized investment tax credits of Taxpayer with respect to public utility property." See Exhibit 106 at p. 3.[1] Private letter rulings are entitled to evidentiary weight, are relied upon by courts as an instructive tool, and are helpful in ascertaining doctrines applied by the IRS. See Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962); O'Shaughnessy v. Commissioner, 332 F.3d 1125, 1131 (8th Cir. 2003); Thom v. United States, 283 F.3d 939, 934 (8th Cir. 2002); Xerox Corp. v. United States, 656 F.2d 659, 660 (Ct. Cl. 1981).

As explained in the appended chapter from Taxation of Public Utilities, a leading treatise on the subject, "normalization requirements are among the most complex provisions of the federal tax law," and are "complicated by the complexities of the ratemaking process and the

[1] The rules promulgated under Section 46(f), which was itself repealed by the Revenue Reconciliation Act of 1990, are in full force and effect. Internal Revenue Code Section 50(d) states that "rules similar to the rules of the following provisions (as in effect the day before the date of the enactment of the Revenue Reconciliation Act of 1990) apply: ... (2) Section 46(f) (relating to limitation in case of certain regulated companies)." See 26 U.S.C. § 50(d).

lack of detailed comprehensive administrative guidance." See R. Matheny, Taxation of Public Utilities § 9.05 (Matthew Bender, 2010), attached as Ex. A. Although the provisions of Section 46(f) were repealed by Congress, "the requirements of former IRC Section 46(f) continue to apply to public utility property for which the taxpayer claimed ITC [investment tax credit]." Id. "Despite the repeal, Congress clearly intended that the normalization requirements remain intact and continue to apply. Congress manifested its intent by significantly strengthening the sanctions imposed on public utilities that fail to comply with the normalization requirements after 1985." Id., § 9.05[1].

> If a taxpayer fails to meet the normalization requirements for the credit in any tax year ending after December 31, 1985, the taxpayer's tax for the year of the violation is increased in an amount equal to the greater of
>
> * all credits for tax years open under the statute of limitations (i.e., open years) at the time a final determination is rendered ... ; or
>
> * the amount of any unamortized credits of the taxpayer or credits not previously restored to rate base ....
>
> Id., § 9.05[6][d] (original emphasis).

Such a normalization requirement failure can occur when there is a "final inconsistent determination" issued "by a regulatory body" like this Commission "that determines for ratemaking purposes the effect of the credit." Id., § 9.05[6][a]-[b] at pp. 11-12. In the case of KCP&L (which is an "Option 2" taxpayer that ratably flows-through such tax credits[2]), "a determination would be an inconsistent [determination] with Option 2 requirements if cost of service was reduced more than ratably by all or a portion of the ITC." Id., § 9.05[6][b] at p. 12.

Consistent with the treatise, Ms. Hardesty testified that if Staff's recommendation that the Commission reallocate the tax credits between KCP&L and GMO were adopted, the normalization violation would affect not only the Section 48A advanced coal credits, but also all

[2] Hardesty Rebuttal Testimony at 9, 12 (references to "ratable potion of the credit" being used in ratemaking over the life of Iatan 2).

other investment tax credits on the books of KCP&L. See Hardesty KCP&L Rebuttal at 10-11. Specifically, this would require KCP&L to repay the IRS $52,294,411, which consists of (a) $29,151,153 in advanced coal credits that have been claimed, as well as (b) $23,143,258 in other claimed investment tax credits. In addition, KCP&L would lose the ability to offset future tax liabilities with $77,957,534 of advanced coal credits that have not yet been claimed. The total penalty to KCP&L for such a normalization violation would be $130,251,945. Id. at 11; Tr. 3936-37 (Hardesty).

Additionally, because GMO would purportedly receive reallocated tax credits from the Commission, not the IRS, GMO would be subject to a normalization violation and lose all of its existing tax credits, which amount to $3,963,573 for its MPS Division and $287,722 for its L&P Division, for a total of $4,251,295. See Hardesty GMO Rebuttal at 10-11.

B. Amending the Memorandum of Understanding Between the IRS and KCP&L.

The original 2008 MOU between the IRS and KCP&L was modified and amended in 2010 as a result of the arbitration panel's award and order. See Sched. 3 (HC) at pp. 5-9, Harrison Surrebuttal. Section 4 of the Agreement states that it "may be amended by deletion or modification of any provisions, provided such Memorandum is in writing and is signed by all parties to the MOU." Id., Sched. 3 at p. 8.

If directed by this Commission, KCP&L and GMO will seek to modify this MOU consistent with this Commission's order.

C. The Commission Should Not Take Any Action to Punish KCP&L for its Diligence in Pursuing the Section 48A Advanced Coal Tax Credits.

As Ms. Hardesty testified, in 2006 KCP&L undertook an investigation of its eligibility for the advanced coal credits after Congress passed the Energy Policy Act of 2005. Tr. 3911-13. The promotion of investment and infrastructure in the electric utility industry was a major

objective of the Act, which contained many tax incentives. See Sections 1305-1351, Title XIII, Energy Policy Act of 2005, Public Law 209-58. Among them were new investment tax credits for clean coal facilities that produced electricity. Id., Section 1307, codified as 26 U.S.C. Section 48A.

Despite the fact that these new laws passed by Congress were obviously not a secret, and were the subject of public IRS notices, such as Notice 2007-52, 2007 WL 1636958 (Released June 7, 2007), KCP&L was the only utility owner of Iatan 2 that pursued the opportunity. Although a tax-paying investor-owned utility, Empire did not conduct any research regarding the tax credits. It is likely, however, that Aquila, burdened by substantial net operating losses, did not apply for the tax credits because it would have been unable to use them. At that time Aquila had no federal tax liability and was paying no taxes. See Sched. 7-2 & 8-1, Harrison Surrebuttal. Both Empire and Aquila failed to submit timely applications to the IRS. Neither MJMEUC nor KEPCo pursued the matter either.

Empire, MJMEUC and KEPCo jointly initiated arbitration proceedings against KCP&L in 2009, but only Empire prevailed. MJMEUC and KEPCo were denied relief as they are not tax-paying entities. See Sched. 1 (HC), Harrison Surrebuttal. As a result of the arbitration order, Empire and KCP&L were able to negotiate new MOU's with the Internal Revenue Service.

Although Staff has criticized KCP&L for its failure to look out for the interests of Aquila, now GMO, the reallocation that occurred in 2010 was the result of the arbitration order. In an effort to conclude the dispute with Empire, KCP&L gave up its right to appeal the arbitration order through the courts in exchange for a solution that would not result in a normalization violation.

KCP&L was also concerned that it would be criticized for taking action favoring the interests of GMO because it would be viewed as contrary to KCP&L's own interests and that of

its customers. Given that KCP&L's conduct was consistent with the best interests of its customers, the Commission should not take any action to harm either KCP&L or its customers.

D. The Arbitration Order is Not Binding Upon This Commission, Particularly as it Misinterpreted the Iatan 2 Owner's Agreement.

Staff and other parties seek to mischaracterize the relationship of KCP&L and the other co-owners of Iatan 2. Mr. Harrison, who is neither a lawyer nor a certified public accountant (Tr. 3952, 3956-57), testified on several occasions that the owners were "partners" and were part of a "partnership agreement." See Harrison Surrebuttal at p. 2, line 23; p. 3, line 6; p. 4, line 12; p. 8, line 18; p. 13, lines 1, 7-11. On cross-examination, Mr. Harrison conceded that he was not familiar with Subchapter K (the partnership section of the Internal Revenue Code), had never seen a partnership agreement, and did not know the characteristics of a partnership as contrasted with a corporation. Tr. 3954-57.

As the evidence made clear, the Iatan owners are "tenants in common, each with an undivided ownership interest therein ...." See Iatan 2 Agreement, Exhibit 105 at p. 1 (#0010). Section 9.1(a) of the Iatan 2 Agreement specifically stated that the owners excluded themselves from the application of Subchapter K of the Internal Revenue Code, which is the partnership subchapter. Id. at p. 37 (#0046). More specifically, the Agreement stated: "In this regard, the Owners do not intend to create any joint venture, partnership, association taxable as a corporation, or other entity for the conduct of any business or profit." Id. [emphasis added].

Section 9.1(b) of the Agreement stated that the owners "shall each separately report and pay for all real property, franchise, business, or other taxes and fees ... arising out of the acquisition, construction, operation, disposition and co-ownership of Iatan 2; ...." Id. As tenants in common, each owner possessed a certain percentage that was fixed in the Iatan 2 Agreement.

Under the Agreement, the owners are "tenants in common, each with an undivided ownership interest."[3]

Although the language of the Final Arbitration Award is harsh, the truth is that KCP&L acted with diligence to take advantage of a tax credit that was well publicized when the Energy Policy Act of 2005 was passed and was a matter of public record. None of the other co-owners who resorted to arbitration were aware of the possibility of applying for tax credits until KCP&L's success was publicly announced. Given that the owners of Iatan 2 are not partners and were each responsible for managing their own tax matters, there is no reason for the Commission to adopt the findings and conclusions of the arbitration, and apply them to GMO.

E. The Fees Expended in Defending the Co-Owners' Claims and Proceeding with Post-Arbitration Matters were Reasonable and Should be Recovered in Rates.

The fees and expenses that KCP&L incurred in defending itself against the arbitration claims of Empire, MJMEUC and KEPCo preserved tax credits for its customers. After the arbitration order was issued, the efforts that were taken to preserve KCP&L's right to appeal the award, as well as to pursue modifying the MOU with the IRS were also incurred to preserve the tax credits and to avoid a normalization violation.

Empire ultimately received its proportionate share of the $125 million in tax credits, given its 12% interest in Iatan 2. If MJMEUC and KEPCo had been successful, their ownership

[3] Responding to Commissioner Davis's questions at Tr. 3945, in a tenancy in common the owners possess an undivided interest in the property, either shared in equal parts or, as in the case of Iatan 2, according to their ownership percentages. Brooks v. Kunz, 597 S.W.2d 183, 187 (Mo. App. E.D. 1980). Tenancy in common is distinguished from joint tenancy, where the survivor becomes the owner of the entire property, or tenancy by the entirety, a similar concept that can only occur between husband and wife. Montgomery v. Clarkson, 585 S.W.2d 483, 484-85 (Mo. en banc 1979); Montgomery v. Roberts, 714 S.W.2d 234, 235-36 (Mo. App. E.D. 1986). Missouri law favors tenancy in common as Section 442.450, Mo. Rev. Stat. (2000), states: "Every interest in real estate granted or devised to two or more persons ... shall be a tenancy in common, unless expressly declared, in such grant or devise, to be in joint tenancy."

percentages (11.76% and 3.53%, respectively, as noted in Ex. 107, p. 12) would have further diluted KCP&L's tax credits by a ratio reflecting their collective 15.29% interest. Staff Witness Keith Majors agreed that this would have been the result. Tr. 3975-76.

KCP&L's opposition to those claims clearly preserved benefits for its customers, and the expenses incurred in that effort should be recovered in rates. On cross-examination, Mr. Majors agreed that KCP&L's actions did benefit its customers because they preserved the tax credits that KCP&L had obtained on behalf of its customers and defeated the claims of KEPCo and MJMEUC. See Tr. at 3975-77. Therefore, the cost of defending the arbitration and the actions taken post-award should not be the subject of an adjustment.

II. Proposed Findings of Fact and Conclusions of Law.

A. Proposed Findings of Fact.

1. When Congress passed the Energy Policy Act of 2005, it enacted a series of tax incentives including what became Section 48A of the Internal Revenue Code, 26 U.S.C. § 48A, that provided $500 million of advanced coal project tax credits.

2. In 2007 KCP&L applied for and received from the IRS $125 million worth of advanced coal project credits related to Iatan 2. KCP&L signed a Memorandum of Agreement (MOU) regarding the award of the credits with the IRS in the summer of 2008. None of the other co-owners of the Iatan 2 project (Aquila, Empire, MJMEUC and KEPCo) applied for such credits in 2007. When Empire and GMO (the former Aquila) submitted applications in 2008, they were denied by the IRS. Neither MJMEUC nor KEPCo submitted any application to the IRS.

3. Empire, MJMEUC and KEPCo initiated arbitration proceedings against KCP&L, claiming that they were either entitled to their proportionate share of the tax credits (representing their share in the Iatan 2 project) or the monetary equivalent thereof.

4. In December 2009 an arbitration panel denied the claims of MJMEUC and KEPCo, but found in favor of Empire. The panel directed KCP&L and Empire to apply to the IRS for an amendment of the 2008 MOU to allow Empire to share in the Section 48A tax credits equal to $17,712,500.

5. KCP&L and Empire applied to the IRS for a reallocation of the Section 48A advanced coal project credits. A revised MOU between the Internal Revenue Service and KCP&L was agreed to by the IRS on August 19, 2010 and delivered to KCP&L on September 9, 2010. This revised MOU reallocated the advanced coal project credits between KCP&L and Empire in the amounts of $107,287,500 and $17,712,500, respectively.

6. The Commission is not bound by the decision of a private arbitration panel conducted pursuant to the provisions of the Iatan 2 Agreement. Because GMO's predecessor Aquila, a tax-paying investor-owned utility, had substantial net operating losses in 2006-07, was not paying taxes, and did not submit a timely application to the IRS for Section 48A advanced coal project credits related to Iatan 2, there is no basis to reallocate tax credits from KCP&L to GMO.

7. Since the parties to the Iatan 2 Agreement are tenants-in-common, and not partners or joint venturers, each party was responsible for its own tax matters and for submitting its own tax filings to the IRS. Section 9.1(a) of the Iatan 2 Agreement explicitly states that the co-owners did not intend to create a partnership, and Section 9.1(b) states that "to the extent possible" the co-owners "shall each separately report and pay for all real property, franchise, business, or other taxes and fees ...."

8. [Alternate Proposed Finding of Fact] Although the Commission is not bound by the decision of the arbitration panel in the Empire case, it finds that KCP&L should have advised Aquila of the availability of Section 48A credits.

9. Any reallocation of tax credits at this time must be accomplished by an amendment to the 2010 MOU to which KCP&L and the IRS are parties. Any attempt by this Commission to reallocate tax credits or indirectly to accomplish a reallocation through adjustments to rate base would likely constitute a normalization violation.

10. A normalization violation would eliminate the value of tax credits for both KCP&L and GMO, causing harm to both of the companies and their customers. Therefore, the Commission finds that KCP&L and GMO should apply to the IRS for an amendment of the 2010 MOU to reallocate the advanced coal project credits that KCP&L now holds in revised amounts by a ratio that would reflect the proportionate ownership interests of KCP&L at 54.71% and GMO at 18.00% (without regard to the ownership percentages of MJMEUC and KEPCo), that is, $80,725,000 and $26,562,500, respectively.

11. The expenses that KCP&L incurred in defending the arbitration claims brought by Empire, MJMEUC and KEPCo, including efforts taken after the arbitration award was issued to preserve the appellate rights of KCP&L while it approached the IRS to amend the 2008 MOU, were reasonably designed to preserve the tax benefits that accrued to KCP&L and its customers. Such expenses should not be the subject of an adjustment.

B. Conclusions of Law.

1. This Commission is not bound by the decision of a private arbitration panel pursuant to the Iatan 2 Agreement. See Jim Walter Resources, Inc. v. Federal Mine Safety and Health Review Comm'n, 920 F.2d 738, 749-50 (11th Cir. 1990) (regulatory commission need not defer to an arbitrator's award).

2. The Commission concludes that the actions taken by KCP&L with regard to the Section 48A advanced coal tax credits were reasonable and that no reallocation of those tax credits either by this Commission or the IRS is warranted.

3. [Alternative Conclusion of Law] A normalization violation will likely result if this Commission orders a reallocation of the tax credits between KCP&L and GMO. See § 211(b), Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong., 2d Sess. (1986); Treas. Reg. 1.46-6; Private Letter Ruling 200945006 (Nov. 6, 2009) (KCP&L Exhibit 106). See generally R. Matheny, Taxation of Public Utilities (Matthew Bender, 2010), § 9.05, Investment Tax Credit Normalization Requirements (attached as Exhibit A).

4. Given the Commission's findings that KCP&L should have brought the matter of the Section 48A tax credits to the attention of Aquila, the Commission directs KCP&L and GMO to apply to the IRS for an amendment of the 2010 MOU that if agreed to by the IRS would allow GMO to obtain a share of the Section 48A tax credits equal to its ownership share of Iatan 2 (without regard to the ownership shares attributable to MJMEUC and KEPCo) and a reallocation of credits in the amounts of $80,725,000 for KCP&L and $26,562,500 for GMO.

WHEREFORE, Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company request that the Commission issues its order consistent with the foregoing positions.

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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the above and foregoing was served upon counsel of record on this 10th day of March, 2011.

/s/ Karl Zobrist
Karl Zobrist

TAXATION OF PUBLIC UTILITIES

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II Income Tax Allocation and the Normalization Process
CHAPTER 9 Investment Tax Credit: Overview and Normalization Requirements

1-9 TAXATION OF PUBLIC UTILITIES § 9.05

§ 9.05 Investment Tax Credit Normalization Requirements

The normalization requirements limit the amount of ITC benefits that may be flowed-through to ratepayers over a specified period of time. Congress believed that allowing immediate flow-through of the ITC benefits to ratepayers was inconsistent with the broad economic policy goals of the ITC. It had not intended for the ITC to stimulate consumption of any specific product or service. A reduction in cost of service for the tax benefit provided by the ITC amounted, in the view of the Congress, to a flow-through of tax revenues to the utility consumer and as such was an unintended subsidy of utility services by the federal government on behalf of the ratepayers. n124 In addition, the impact on federal revenues attributable to the flow-through of the credit was believed by Congress to be twice as large as the cost of the credit claimed by nonregulated industries because of the tax-on-tax effect of the ratemaking process: n125 The flow-through of the ITC resulted not only in a direct reduction in the federal income tax paid by the regulated enterprise, but also in an indirect reduction of tax because of the corresponding decrease in the rate revenue requirement from the lower cost of service. n126

To counter these problems, Congress enacted the core of the current normalization rules for the ITC as part of the Revenue Act of 1971, n127 the same legislation that restored the credit after its repeal in 1969. These normalization rules were effective after December 10, 1971 and continue to apply today with some modifications expanding their scope and further restricting flow-through of ITC benefits. Regulatory guidance on these complex rules is limited to regulations issued in 1979. n128 The regulations address normalization requirements imposed by the Revenue Act of 1971. The regulations under IRC Section 46(f) do not address subsequent amendments to the statute. n129 other than the redesignation of IRC Section 46(e) to IRC Section 46(f) by the Tax Reform Act of 1975. n130

Comment:
Subsection (e) of IRC Section 46, which set forth the normalization requirements for ITC as imposed by the Revenue Act of 1971, was

redesignated subsection (f) by the Tax Reduction Act of 1975. For purposes of clarity, this chapter will reference the ITC normalization requirements to IRC Section 46(f).

The normalization requirements are among the most complex provisions of the federal tax law. Application of these rules is complicated by the complexities of the ratemaking process and the lack of detailed comprehensive administrative guidance. These provisions continue to be applicable to public utility property for which ITC was claimed. The regulations issued under former IRC Section 46(f), together with numerous private letter rulings issued by the Service, comprise the primary guidance available to the industry for application of the complex ITC normalization provisions.

Comment:

IRC Section 46(f) was repealed as "deadwood" by the Revenue Reconciliation Act of 1990. n131 n132 Despite its repeal, the requirements of former IRC Section 46(f) continue to apply to public utility property for which the taxpayer claimed ITC. Many types of public utility property are long-lived. Consequently, the normalization rules of former IRC Section 46(f) continue to apply to substantial amounts of property currently being depreciated by the industry.

The normalization requirements for ITC are similar in purpose and concept to the normalization requirements for depreciation. Each set of requirements placed restrictions on many utilities regarding the immediate flow-through of tax benefits to ratepayers. The normalization requirements for ITC, as well as accelerated depreciation, do not require the attendant tax benefits to be shared with a utility's ratepayers. Instead, the normalization requirements place limits on the amount of the tax benefit that could be allocated to ratepayers. (See Chapter 8 for a discussion of the normalization rules applicable to accelerated tax depreciation.)

This section discusses the normalization requirements as they exist today. The chronological development of the normalization rules is discussed in § 9.06, below.

[1] Overview

The Tax Reform Act of 1986 repealed the ITC effective generally for property placed in service after 1985, subject to transition rules discussed at § 9.02[3][a]. Despite the repeal, Congress clearly intended that the normalization requirements for ITC remain intact and continue to apply. Congress manifested its intent by significantly strengthening the sanctions imposed on public utilities that fail to comply with the normalization requirements after 1985. n133 (See § 9.05[4][d] for a discussion of the sanctions.)

The normalization requirements for ITC added to the statute by the Tax Reform Act of 1971 provided three options for the treatment of ITC. n134 As discussed below, the third option, permitting immediate flow-through of the credit in limited cases, was repealed by the Economic Recovery Tax Act of 1981.

Comment:

> The ITC normalization requirements embodied by the three options of IRC Section 46(f) remain extremely important for public utilities. Most utilities continue to report large amounts of unamortized ITC for regulatory and financial accounting purposes. The ratemaking and regulatory reporting treatment of these amounts remain subject to the normalization requirements. Because of the typically lengthy life of public utility property, the importance to public utilities of the normalization requirements for ITC will continue well into the 21st century.

A summary of each of the options under IRC Section 46(f) is presented below:

Option 1--The first option represents the general rule under IRC Section 46(f) and applies to taxpayers who did not elect Option 2 or Option 3 in 1972. The provisions of Option 1 also may apply to the additional ITC provided by Congress in the Tax Reduction Act of 1975. (See § 9.06 [3], below.) Cost of service, under Option 1, is not reduced by any amount of the credit allowed on the public utility property. Rate base may be reduced, however, by the amount of the tax benefit obtained by the credit provided that the rate base reduction is restored (i.e., the reduction is reversed) no slower than over the useful life n135 of the property. Failure to meet the requirements of the general rule, as applicable, results in disallowance of the credit otherwise allowable on the investment by the taxpayer in public utility property. (See § 9.05[4][d], below.)

Option 2--Option 2 allows for a ratable flow-through of the credit. This option must have been elected irrevocably by the utility in 1972 or in 1975 (by eligible taxpayers wanting Option 2 treatment for the additional credit provided in the Tax Reduction Act of 1975). If not, it is unavailable. (See § 9.06[3], below.) Under Option 2, an ITC is not allowed for public utility property if the credit otherwise allowable to the taxpayer is flowed through to cost of service more rapidly than ratably over the life of the property. Taxpayers electing Option 2, however, may not reduce rate base by any portion of the credit. This election for Option 2 was irrevocable and applied to all of the taxpayer's public utility property, whether or not the taxpayer was regulated by more than one regulatory agency. n136

Option 3--Before 1981, public utilities had a third option, *Option 3*, that allowed immediate flow-through of ITC benefits if the property qualified for flow-through treatment under the depreciation normalization rules (generally if the utility had used flow-through for its pre-1970 property). (See § 9.06[2], below, for a detailed discussion of this option; Chapter 8 discusses the depreciation normalization rules.) This immediate flow-through option was eliminated for both ITC and depreciation by the Economic Recovery Tax Act of 1981. The net effect of repeal of the flow-through method for ITC required taxpayers who had elected Option 3 flow-through to account for ITC under the general rule of Option 1, unless it had elected Option 2's ratable flow-through in 1972 or 1975.

Property subject to the normalization requirements for ITC is referred to as IRC Section 46(f) property. (See § 9.04 for the definition of public utility property.)

Comment:

Although the ITC was repealed with the Tax Reform Act of 1986,

Congress greatly strengthened the ITC normalization requirements in the same legislation by increasing the severity of the possible sanctions imposed in the event of their violation. Taxpayers must continue to account for the credit in a manner consistent with the provisions of Option 1 and Option 2, as applicable. Both options provide for a ratable amortization of the ITC (a ratable rate base restoration in the case of Option 1) over the regulatory life of the underlying property. Given the long life assigned to many types of public utility property for ratemaking purposes, the amortization of ITC earned before its repeal will continue for several decades. Consequently, even though the ITC is not available under current law, the normalization requirements for the ITC remain relevant until well into the 21st century.

[2] Option 1: General Rule

IRC Section 46(f)(1) provides the rather convoluted general rule, referred to as Option 1, which limits the use of ITC for certain regulated utilities. An election was not required to implement Option 1. It applies to all of a taxpayer's IRC Section 46(f) property if the taxpayer did not make an irrevocable election to use Option 2 or Option 3 in 1972.

Comment:
If an election was made by the taxpayer under Option 2, Option 1 does not apply to any of the taxpayer's IRC Section 46(f) property. If a taxpayer had made an election to use Option 3's immediate flow-through method for its pre-1981 eligible property, Option 1 still applies to the taxpayer's property ineligible for that election if no election was made under Option 2. n137

Under the general rule of Option 1, the ITC may not be flowed-through to ratepayers by means of a reduction to the taxpayer's cost of service and the tax benefit provided by the credit may not be used to reduce rate base. Accordingly, subject to the exception discussed below, the general rule of Option 1 denies any sharing of the tax benefit allowed by the ITC between the shareholders and the ratepayers--no portion of the credit may serve to reduce the taxpayer's rate revenues. If cost of service is reduced or a reduction to rate base for the tax benefit of the ITC is made (subject to the exception discussed below), the credit claimed with respect to the taxpayer's IRC Section 46(f) property is disallowed.

[a] Exception for Ratable Restoration of Rate Base Reduction

IRC Section 46(f)(1) also allows, under Option 1, a departure from the general rule by permitting a reduction to rate base provided that, once a reduction is made, it is restored (i.e., the reduction is reversed) ratably or faster than ratably. n138 A taxpayer was permitted to elect out of this exception back in 1972 for certain specified property. (See § 9.05[2][b], below.)

Comment:
For purposes of determining whether a restoration to rate base is made at least as rapidly as ratably, the applicable restoration period is the period used to compute depreciation expense for the taxpayer's regulated books. n139 The depreciable life of the property for federal

income tax purposes is not relevant for purposes of determining the ratable restoration requirement.

Example:
Utility *X*, a regulated company owning and operating public utility property uses Option 1. On the first day of its tax year ended December 31, 1984, Utility *X* placed into service public utility property with respect to which $1 million of ITC is claimed under IRC Section 38. The useful life of the property for regulatory purposes is 25 years. Under the general rule of Option 1, no portion of the $1 million credit may be used to reduce cost of service for purposes of establishing the required rate revenue of Utility *X*. Accordingly, the accounting entry (simplified for illustrative purposes) to record the ITC under the general rule of Option 1 was as follows:

Debit

Taxes Payable ....$1 million

Credit

Accumulated Deferred ITC $1 million

Because Option 1 prohibits the flow-through (immediately, ratably, or otherwise) of the credit to cost of service, the ITC instead must be flowed through "below the line" (i.e., the tax benefit is not included in the determination of the utility's cost of service).

The general rule of Option 1 prohibits a reduction to the rate base of Utility *X* for any portion of the credit. Under the exception to the general rule of Option 1, however, rate base may be reduced by all or part of the ITC, provided that the reduction is restored no less rapidly than ratably. Restoration of the reduction of the credit ratably over the 25-year life of the property results in a required annual restoration (i.e., a decrease in the rate base reduction) of $40,000 ($1 million/25 years). Accordingly, the rate base of Utility *X* may be reduced by the $1 million credit provided that the reduction is reversed in an amount no less than $40,000 per year.

Comment:
From an accounting perspective, the amortization of the rate base reduction allowed under Option 1 is accomplished by debiting accumulated deferred investment tax credit and crediting income for the appropriate amount. Note that the credit to income is "below the line"--the credit amortization is not included in regulated cost of service. This treatment can be contrasted with the accounting for the deferred ITC under Option 2 (discussed in § 9.05 [3]). The credit to income for an Option 2 taxpayer is accounted for "above the line." The amortization of the ITC is allowed to reduce cost of service under Option 2; the deferred credits of an Option 2 taxpayer, however, may not be used to reduce rate base.

[b] Short Supply Election

The "short supply" election allowed public utilities to avoid reducing rate base

(and its consequent restoration). n140 An election made for short supply property applies to all of a taxpayer's IRC Section 46(f) property to which Option 1 applies and which is "short supply property" (as defined below). n141

Comment:
Utilities that made the short supply election in 1972 must continue to apply these rules to all of their short supply property for which they have claimed ITC.

If the election was made, any reduction (with or without a ratable restoration) of the taxpayer's rate base by the ITC would result in a violation of the normalization requirements. The short supply election prohibits any flow-through of the credit to cost of service and any rate base reduction. The net effect of this election, therefore, is to award the entire benefit of the credit to the shareholders (as opposed to a sharing of the benefit with the utility's ratepayers). The short supply election was available to taxpayers only when the federal agency that regulates its rates determines that the natural domestic supply of the product sold or furnished by the taxpayer in its regulated business is insufficient to meet the current and future requirements of the domestic economy. n142

The election for short supply property was provided by Congress to encourage investment and expansion of certain natural domestic resources by permitting the entire benefit of the credit to be used as an incentive to encourage expansion or at least maintenance of the supply. n143

The election brings short supply property back within the general rule of Option 1, with the exception from the general rule allowing a rate base reduction if it is restored at least ratably (discussed at [2] [a], above) not applying. This election bars a regulator from requiring a rate base reduction for any portion of ITC claimed in relation to short supply property. Any rate base reduction would result in disallowance of the credit, even if the rate base reduction was restored no less rapidly than ratably.

Short supply property is IRC Section 46(f) property if:

- it is used predominantly in the business of the furnishing or sale of steam through a local distribution system or of the transportation of gas or steam by pipeline if the rates for the business are regulated within the meaning of Regulations Section 1.46-3(g)(2)(iii); n144

- the regulatory body with jurisdiction over the taxpayer for ratemaking purposes with respect to the public utility activity is an agency or instrumentality of the U.S.; and

- the regulatory body makes a "short supply determination" n145 that is in effect on the date the property is placed in service. n146

[3] Option 2: Ratable Flow-Through Election

Option 2 allows ratable flow-through of ITC to cost of service. This method was available to a taxpayer if a timely affirmative election was made in 1972 n147 (or in 1975 for eligible taxpayers; see § 9.06[3]).

Comment:
If an election was made to use Option 2, it applies to all of the taxpayer's IRC Section 46(f) property, except to the extent Option 3's immediate flow-through was elected for eligible pre-1981 property (see § 9.06 [2] for discussion of Option 3). An Option 2 election precludes application of Option 1 rules to any of the taxpayer's IRC Section 46(f) property. n148

If a taxpayer made a timely election of Option 2, Option 1 and its rate base reduction provision does not apply to the taxpayer's IRC Section 46(f) property. Therefore, a rate base reduction for any portion of the ITC results in forfeiture of the ITC, regardless of whether the reduction is restored ratably. Under Option 2, however, cost of service *may be reduced* ratably (or less than ratably) by the ITC otherwise allowable with respect to IRC Section 46(f) property.

The term "ratably" for this purpose is determined by reference to the useful life of the property for regulatory purposes. n149

Note:
If the regulatory depreciable life of the property had not yet commenced (as was generally the case with ITC claimed on qualified progress expenditures), the credit could not be used to reduce cost of service under Option 2 until the related property was placed in service and depreciation commences for regulatory purposes. n150

Option 2 disallows ITC if either of two circumstances exist:

(1) cost of service for ratemaking purposes or in the taxpayer's regulated books is reduced *by more than a ratable portion* of the credit; or

(2) the taxpayer's rate base is reduced *by any portion* of the credit.

Example:
Utility *Y*, a regulated company owning and operating public utility property, is subject to Option 2. On the first day of its tax year ended December 31, 1984, Utility *Y* placed into service public utility property with respect to which $1 million of ITC was allowable under IRC Section 38. The useful life of the property for regulatory purposes is 25 years. The initial accounting entry (simplified for illustrative purposes) to record the credit is as follows:

Debit

Taxes Payable

....

.$1 million

Credit

Accumulated Deferred ITC $1 million

Under Option 2, no portion of the $1 million credit can be used to reduce the rate base of Utility *Y*. However, the ITC may be used to reduce cost of service, as long as the reduction does not exceed a ratable portion of the credit. Based on the 25-year life of the

property, Utility Y's cost of service may be reduced by up to $40,000 ($1 million/25 years) per year. The accounting entry to record the annual amortization is as follows:

Debit

Accumulated Deferred ITC $40,000

Credit

Tax Expense (Cost of Service)	$40,000

Comment:
The ratable amortization requirement of Option 2 establishes a ceiling on the amount of accumulated deferred ITC that may be flowed-through to ratepayers in a given year. If permitted by their regulator, Option 2 taxpayers can flow-through a lesser amount of the credit to cost of service.

A taxpayer electing Option 2 must use the same ratable flow-through method in its regulated books of account as is used in establishing cost of service for ratemaking purposes. Accordingly, a regulatory agency cannot require a taxpayer to treat the credit in its financial statements to its shareholders or to the public in a manner different from the treatment afforded the credit for purposes of establishing cost of service. n151 The denial of the credit because of a ratemaking treatment of the credit inconsistent with the normalization requirements ceases once the regulatory agency puts into effect a determination consistent with these provisions. n152 (See § 9.05[4], below.)

The regulations under IRC Section 46(f) were amended in 1986 n153 expressly to approve the use of the interest synchronization method in calculating ratemaking tax expense for Option 2 taxpayers and, subject to certain limitations, the use of zero-cost capital in determining the rate of return assigned to the credit. Interest synchronization is not allowed for Option 1 taxpayers. Interest synchronization and zero-cost capital are discussed at § 9.08[6].

[4] Option 3

IRC Section 46(f)(3) provided a third option at the election of the taxpayer regarding the allowable ratemaking treatment of the ITC. Option 3 permitted electing taxpayers to flow-through the entire ITC to ratepayers. Option 3 was available, however, only with respect to public utility property for which the taxpayer was permitted to use the flow-through method of accounting under the normalization rules for accelerated tax depreciation. n154 Option 3 was repealed by Congress as part of the Economic Recovery Tax Act of 1981, effective for property placed in service after 1980. The immediate flow-through method of Option 3 is discussed at § 9.06 [2], below.

[5] The "Additional Credit" of the Tax Reform Act of 1975

Additional normalization requirements were imposed by Congress to accompany the enhancements to the general ITC provisions provided by the Tax Reduction Act of 1975. The new requirements were intended to reduce further the amount of the ITC immediately flowed through to ratepayers by the nation's public utilities. The new rules provided that the various increased ITC benefits added by the 1975 Act

(collectively labeled the "additional credit") could not be immediately flowed through to ratepayers by Option 3 taxpayers, absent an additional election to do so, solely at the taxpayer's option. Certain Option 3 taxpayers, unwilling to immediately flow-through the additional credit, could separately elect to apply Option 2 to the increased credit benefits provided by the 1975 Act. n155 The normalization requirements for the additional credit are discussed at § 9.06[3], below.

[6] Failure to Normalize

The failure to comply with the normalization requirements under IRC Section 46(f) (referred to as a "normalization violation") results in the disallowance of all ITC claimed by the taxpayer for IRC Section 46(f) property in tax years not barred under the statute of limitations. n156 Furthermore, no credit is allowed with respect to IRC Section 46(f) property placed into service after the normalization requirements are violated by an inconsistent determination (defined below) until a subsequent determination, consistent with the requirements of IRC Section 46(f), is put into effect. n157 The penalty for failure to comply with the ITC normalization requirements can be enormous. Nevertheless, Congress clearly believed that the "penalty fits the crime." n158

Comment:

Increased sanctions included in the Tax Reform Act of 1986 (TRA 1986), applicable to post-1985 violations, can require much more than the recapture of ITC earned with respect to IRC Section 46(f) property in open tax years; the TRA 1986 sanctions also require *any unamortized credits to be recaptured (whether or not claimed in open tax years)* to the extent that the unamortized credits exceed the amount subject to recapture under the regular rules.

In PLR 200802025 , October 10, 2007, the IRS concluded that regulated utilities using a composite depreciation method with the practical effect of flowing ITC to ratepayers more rapidly than permitted by former IRC Section 46(f)(2)(A) should not be required to recapture such ITC because neither the utilities nor their regulators intended the more rapid flow-through.

Each of the utilities used a composite depreciation rate based upon the estimated useful lives of various functional groups for depreciable assets. The cost basis of the assets in each functional group was reduced by the estimated net salvage value of the component assets. Because of the nature of the depreciable assets, in most cases the costs of salvage exceeded the realizable salvage values, resulting in a net negative salvage value. Including net negative salvage values in the calculation of the composite annual depreciation rate had the practical effect of depreciating the assets over a period that was somewhat shorter than the estimated useful lives. Since the utilities, under these respective rate orders, were flowing the ITC through to the ratepayers based upon depreciation periods, such ITC were also being flowed through more rapidly than permitted by former IRC Section 46(f)(2)(A).

After analyzing the statutory requirements, the IRS concluded that the utilities had not intended to accelerate the ITC flow through and that their respective regulators had relied upon the calculation and methods of the utilities in good faith. Under the circumstances the IRS concluded that neither disallowance nor recapture of the ITC was warranted. In reaching this conclusion the IRS relied

upon the congressional record showing that disallowance or recapture was intended to be an extraordinary remedy usually applied when regulators required more rapid flow through.

The IRS used a similar analysis to reach a similar conclusion in PLR 200811004 , December 4, 2007. In this PLR the taxpayer was a regulated utility owning a nuclear generating facility that had an original 40 year operating license. The assets in the utility's rate base were accordingly depreciated over one 40 year life. In connection with a subsequent application for a rate increase, the utility's regulator ordered the depreciable life of the nuclear generating facility extended from 40 years to 60 years. The rate application was concluded by stipulation rather than by a general rate order. The taxpayer adjusted its depreciation charges to reflect the longer regulatory life but neglected to adjust its accumulated deferred investment tax credit (ADITC) and its excess deferred income taxes (EDFIT). After some period of time the taxpayer recognized its oversight and voluntarily adjusted its ADITC and EDFIT to recapture the amounts of ITC and deferred taxes with respect to accelerated depreciation that had reduced its rates for the period of the error.

In concluding that disallowance of the ITC would not be required the IRS considered the facts that (i) the more rapid flow-through of ITC and excess deferred were unintended by either the utility or its regulator and (ii) the utility promptly adjusted its accounts and charges upon realizing its error. The IRS also noted that the more rapid flow-through had not been "required or insisted upon" by the regulator authority.

The IRS takes up the question of good faith error with respect to the normalization requirements in PLR 200933023 . The taxpayer, a rate regulated electric power company, had self-identified three separate kinds of normalization violations. First, the taxpayer had extended the estimates of useful life for some of its assets and received permission from its regulators to recover the undepreciated costs of such assets over the longer period. Secondly, the taxpayer had included negative salvage (the amount by which salvage and other disposition costs are estimated to exceed salvage revenues) in its composite depreciation rate which had the effect of increasing that rate. In both of these cases the taxpayer had failed to reflect the changes in its depreciation lives and rates on the investment tax credits it was normalizing resulting in the amortization of the taxpayer's accumulated deferred investment tax credits ("ADITC") at rates which differed from those used in setting taxpayer's rates. The third normalization violation occurred as a result of the taxpayer's method of normalizing contributions in aid of construction which inadvertently resulted in less than full normalization of the taxpayer's depreciation expenses. The taxpayer used the "non-inclusion method" of accounting for CIAC in its regulatory accounting. Under the non-inclusion method, the taxpayer disregards the receipt of CIAC and does not reflect the receipt of CIAC property in its income cost of service or rate base. For regulatory tax purposes the taxpayer is treated as having received the CIAC property and entirely depreciated it in the year of receipt. The IRS believes that this regulatory tax expense treatment is necessary to normalize CIAC under the non-inclusion method. n158.1 Under the facts set out in the taxpayer's request for a private letter ruling the IRS concluded that although there were normalization violations in all three scenarios, neither the taxpayer nor its regulators intended the violations and that the severe penalty established by Treas Reg Section 1.46-6(f)(4) was not warranted. The IRS specifically noted that relevant orders of the regulator mandated full normalization and that the

taxpayer had self-identified the violation.

While a PLR or two hardly constitute a theme, it seems reasonable to assume that the IRS will not use its power to disallow ITC where such ITC is flowed through more rapidly than permitted by former IRC Section 46(f)(2)(A) because of errors and omissions and that this extreme remedy will be applied generally where more rapid flow-through is mandated by renegade regulatory authorities.

[a] ITC Disallowed

The ITC is disallowed when a first final determination inconsistent with the applicable normalization requirements is put into effect with respect to the taxpayer's public utility property. n159 The credit is also disallowed when any inconsistent determination (whether or not a final determination) is put into effect following the date the first final inconsistent determination was put into effect. n160 No disallowance of the credit due to a violation of the requirements of IRC Section 46(f) occurs before the first final inconsistent determination is put into effect with respect to a taxpayer's IRC Section 46(f) property.

The credit was not disallowed merely because the terms of a prior rate order issued before the 1971 enactment date of the Revenue Act of 1971 were inconsistent with the requirements of IRC Section 46(f). n161

Comment:
The limitations of the applicable normalization option had to have been met in the first final determination put into effect after the date of the enactment of the 1971 Act and in every determination (whether or not final) thereafter. A sanction was not applied merely because a prior order (e.g., one issued in 1968) required excessive flow-through or rate base adjustments. If the first order after the 1971 Act's enactment was inconsistent with the limitations of the applicable option, it did not result in disallowance until the order had been affirmed through the appellate process or the company had let its right of appeal expire, and the order had been put into effect. n162

The ITC disallowed by the limitations of IRC Section 46(f) are those credits with respect to the taxpayer's IRC Section 46(f) property placed in service by the taxpayer before the date the inconsistent final determination is put into effect. No credit is disallowed, however, with respect to any tax year for which an assessment of deficiency is barred by any law (i.e., years closed under the statute of limitations). n163

In addition to the disallowance of all applicable ITC claimed in open tax years, credits with respect to IRC Section 46(f) property placed in service on or after the date of the final inconsistent determination are also disallowed until the date a subsequent consistent determination is put into effect. n164 A determination is considered "put into effect" on the *later* of (1) the date such determination is issued (in the case of the first final inconsistent determination, on the date it becomes final), or (2) the date such determination becomes operative. n165

[b] Determination Defined

For purposes of IRC Section 46(f), the term "determination" refers to a determination made with respect to IRC Section 46(f) property by a regulatory body n166 that determines for ratemaking purposes the effect of the credit:

- on the taxpayer's cost of service or rate base for purposes of Option 1, or

- on an Option 2 taxpayer's cost of service (for either ratemaking purposes or in its regulated books), or on its rate base for ratemaking purposes. n167

Comment:
A regulatory body need not take affirmative action to make a determination. The failure to act by a regulatory authority on a rate schedule filed by the taxpayer that is inconsistent with the requirements of Options 1 or 2 (as applicable) may constitute a final inconsistent determination if the rates can be put into effect without further action by the regulatory body. n168

An *inconsistent determination* is one that is inconsistent with either Option 1 or Option 2 (as applicable). A determination is inconsistent with the Option 1 requirements if, for example, cost of service was reduced by all or a portion of the ITC. Similarly, a determination would be an inconsistent with Option 2 requirements if cost of service was reduced more than ratably by all or a portion of the ITC. n169

A *consistent determination* is a determination consistent with the requirements of either Option 1 or Option 2 (as applicable). n170

A *final determination* is a determination with respect to which all rights of appeal or all rights to request a review, rehearing, or redetermination have lapsed or been exhausted. n171

The *first final inconsistent determination* is the first final determination put into effect after December 10, 1971 that is inconsistent with the requirements of either Option 1 or Option 2 (as applicable). A first final determination is considered put into effect on the later of (1) the date it becomes final or, (2) the date it becomes operative. n172

Comment:
Many public utilities operate under the jurisdiction of more than one commission with rate regulation responsibility. In the event that a regulator issues a determination inconsistent with the normalization requirements, the ITC disallowed under IRC Section 46(f) is limited to the amount attributable to the taxpayer's IRC Section 46(f) property within the jurisdiction of that regulator. For this purpose, a regulator is considered to have jurisdiction over a particular property if the property is included in rate base (or expenses for the property are included in cost of service) for which the regulator determines the taxpayer's allowable return for ratemaking purposes. n173

[c] Notification Requirement

The regulations provide that a taxpayer must notify its district director of the

disallowance of ITC within 30 days after an applicable inconsistent determination is put into effect. Furthermore, the taxpayer must recompute its tax liability for any affected tax year and file amended returns as necessary to reflect a revised tax liability. n174

Example

(1): Utility *X* is a calendar-year taxpayer operating under the jurisdiction of Regulator *A*. *X* is an Option 1 taxpayer. On July 1, 1982, Utility *X* filed with *A* for a rate increase effective as of July 1, 1982. *X* purchased and placed in service IRC Section 46(f) property on September 15, 1982, and claimed ITC on the property on its federal income tax return for 1982. *A* makes a determination on May 1, 1983, approving rates based on an historical test period in which cost of service was reduced by the ITC claimed by *X* for 1982. The approved rate schedule was effective retroactively from July 1, 1982, forward. Because *X*'s cost of service was reduced by the ITC, the determination is inconsistent with the general rule of Option 1, which does not allow ITC to reduce cost of service in any manner. The inconsistent determination became final on October 13, 1983. The determination is a first final inconsistent determination.

Because the determination became final on October 13, 1983, the ITC is disallowed retroactively from that date for all tax years with respect to which a deficiency assessment is not barred by any law or rule of law. *X* must notify the district director by November 12, 1983 (i.e., within 30 days of October 13, 1983), and file amended returns, as appropriate, to reflect the disallowed ITC. The ITC also is disallowed with respect to any additional IRC Section 46(f) property that *X* places in service on or after October 13, 1983, until the date that *A* renders a subsequent determination consistent with the requirements of Option 1. n175

Example

(2): Assume the same facts as in Example (1), except that on June 1, 1985, Regulator *A* issued an order requiring *X* to account for the credit on a basis consistent with the requirements of Option 1. The subsequent determination was operative beginning January 1, 1985. The subsequent consistent order is considered put into effect for purposes of IRC Section 46(f) on June 1, 1985 (the date it was issued and became final). Accordingly, *X* may properly claim ITC for public utility property placed in service on or after June 1, 1985. n176

[d] Tax Reform Act of 1986 Sanctions--Increased Tax

The ITC was repealed by Congress in the Tax Reform Act of 1986 (TRA 1986), generally effective for property placed in service after 1985. Even though the credit itself was repealed, Congress strengthened the ITC normalization requirements by clarifying and increasing the sanctions imposed in the event of their violation. If a taxpayer fails to meet the normalization requirements for the credit in any tax year ending after December 31, 1985, the taxpayer's tax for the year of the violation is increased in an amount equal to the *greater of*

- all credits for tax years open under the statute of limitations (i.e., open years) at the time a final determination is rendered

inconsistent with the provisions of Option 1 or 2 as applicable; or

- the amount of any unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not such credits were claimed with respect to property placed in service in closed tax years). n177

Comment:
TRA 1986 Section 211(b) requires much more than just the recapture of ITC earned with respect to IRC Section 46(f) property in open tax years. If a taxpayer fails to comply with the requirements of Option 1 or Option 2, as applicable, *any unamortized credits must be recaptured (whether or not earned in open tax years)* to the extent the unamortized credits exceed the amount of credits claimed by the taxpayer in open years.

If the credits subject to recapture have not yet been utilized by the taxpayer, the ITC carryforward is reduced by the amount of those credits in lieu of recapture. Rules similar to the above requirements also apply to any TRASOP credit subject to the limitations of IRC Section 46(f)(9). n178

Comment:
This provision subjects an Option 1 taxpayer to an increase in tax equal to the balance of its ITC not restored to rate base (i.e., unamortized) as of the time of the inconsistent final determination. Similarly, an Option 2 taxpayer would suffer an increase in tax equal to the amount of ITC not yet amortized (i.e., treated as a reduction to ratemaking tax expense) into cost of service. The provision is particularly significant because of the lengthy regulatory life typical of public utility plant and equipment. Many utilities will have substantial unamortized credits well into the next century. Therefore, the normalization requirements for ITC will remain extremely important for many years.

In PLR 200815004 , January 8, 2008, the IRS reviewed a statutory change in the method of determining the depreciation component of cost of service for rate making purposes in order to determine if the new method violated the normalization requirements of IRC Section 168(i)(9) and former IRC Sections 167(1) and 46(f). The PLR is not particularly instructive with respect to its specific ruling (the IRS concluded that the new method did not appear to violate the normalization requirements) because the description of the new method was redacted. However, the PLR provides an excellent summary of the normalization requirements in general and the tests that are applied to determine if there has been a violation of those requirements. It is also significant that the PLR expressly notes that the ruling deals with anticipated consequences of the new method and that a normalization violation may occur if there are unexpected consequences in its application.

[7] Prohibition Against Inconsistent Estimates and Projections

The inconsistent estimates and projection provision of the Internal Revenue Code, IRC Section 46(f)(10), was enacted by Congress in 1983 to clarify that the "average annual adjustment" (AAA) method, in the context of the investment tax credit (ITC), and similar ratemaking methodologies do not meet the statute's normalization requirements. n179 The AAA method was implemented by the

California Public Utility Commission during the 1970s in a well-known, extended dispute over the ratemaking treatment of accelerated tax depreciation and the ITC of Pacific Telephone and Telegraph (PT&T) and General Telephone and Electronics Corporation (GTE). The enactment of this provision ended one of the most notable normalization controversies since the normalization requirements were added to the Code in the 1960s. (See Chapter 8 for a discussion of the controversy and its historical setting.)

The now-barred AAA method allowed the reduction of tax expense for the test year by a ratable amount of ITC earned for the test year and preceding years. n180 The ITC from future additions to plant and equipment was projected for the period of years beyond the test year covered by the rate order. Cost of service determined for the test year was then reduced by a ratable amount of the credit projected to be earned from the future investment in the first succeeding future year. The rate revenue requirements for the first future year following the test year were reduced accordingly. The amount of ITC projected to be earned on plant additions for the second succeeding future year beyond the test year was then determined. Ratemaking tax expense was reduced further by a ratable amount of this ITC, resulting in a decrease in revenue requirements for the second year succeeding the test year. These steps were repeated for all additional years covered by the order. n181

Depreciation expense, for purposes of determining cost of service, was not adjusted to account for future property and equipment additions under the AAA method. Similarly, rate base was determined on test year balances and was not adjusted for the projected future additions generating the estimated ITC.

Comment:
Before IRC § 46(f)(10) was enacted, the Service issued a private letter ruling stating that the AAA method violated the requirements of Option 2. n182 In this ruling, rate base was not adjusted to reflect the net increase as a result of the anticipated new investments. This treatment resulted in effective reduction of the rate base by reason of the ITC generated by the new investments and, therefore, violated IRC Section 46(f)(2)(B). The facts in the ruling also included use of an accounting treatment that did not adjust the depreciation expense to reflect the net increase in the depreciation base from the anticipated new investment that generated the ITC, which caused the cost of service to be considered to have been further reduced by reason of the ITC in violation of IRC Section 46(f)(2)(A).

Projected reductions in the federal income tax component of cost of service were based on estimated future additions to plant and equipment. But these assumptions were *not* used to adjust cost of service for future years to account for a corresponding increase in regulatory depreciation expense. Similarly, rate base for plant in service was *not* increased by the projected additions in determining the allowable return on investment for these future years. It was precisely this inconsistency in assumptions that caused PT&T and GTE to assert that the AAA method violated the normalization requirements of IRC Section 46(f)(2).

IRC Section 46(f)(10) was added to the Code to halt use of the AAA method and similar methodologies. n183 n184 IRC Section 46(f)(10) prohibits use of inconsistent estimates, projections, assumptions, and the like, in calculating investment credit, depreciation expense, and rate base for ratemaking purposes.

The language of IRC Section 46(f)(10) clearly prohibits the inconsistencies employed in the assumptions under the AAA method to compute the taxpayer's qualified investment in IRC Section 38 property and the assumptions used to determine rate base and cost of service. (See § 9.08, below, for examples of the impact of this rule on the Service's position regarding various ITC normalization issues.)

Comment:
The same legislation added a similar provision to IRC Section 168 n185 to prohibit use of a method similar to the AAA method under the depreciation normalization rules discussed in Chapter 8. The Act also amended former IRC Section 167(l)(3)(G) to state that similar rules apply to public utility property governed by former IRC Section 167. n186

Comment:
The scope of IRC Section 46(f)(10) is seemingly quite broad. Little guidance is available, however, to assist public utilities and their regulators in applying this provision to specific ratemaking computations. The statute authorizes the Treasury to prescribe, by regulation, additional procedures and adjustments that are inconsistent with the general normalization requirements. Regulations providing such guidance have not been issued.

Practice Note:
Taxpayers should carefully review the calculation of ratemaking tax expense and the determination of the amount of the reserve for deferred federal income taxes allowed as a rate base reduction (or treated as zero-cost capital). The assumptions used to compute tax depreciation and ITC amortization (e.g., depreciable lives) *must* be consistent with the assumptions used to compute regulatory depreciation expense and rate base. Any method that lacks this consistency and reduces cost of service or rate base below the amounts derived using consistent assumptions may be found in violation of the normalization requirements and subject the taxpayer to substantial tax deficiencies.

FOOTNOTES:
(n1)Footnote 124. S Rep 92-437, 92d Cong, 1st Sess, 36 (1971).

(n2)Footnote 125. S Rep 92-437, 92d Cong, 1st Sess, 36 (1971).

(n3)Footnote 126. See Ch 8 for an example of the impact of the flow-through method on the tax liability of a regulated utility.

(n4)Footnote 127. Pub L No 92-178, § 105(e) (1971).

(n5)Footnote 128. TD 7602, 1979-1 CB 14 .

(n6)Footnote 129. See generally, IRC § 46(f)(9) and (10).

(n7)Footnote 130. Treas Reg § 1.46-6(a)(1).

(n8)Footnote 131. Pub L No 101-508, § 11812(a)(1-2) (Nov 5, 1990).

(n9)Footnote 132. [Reserved]

(n10)Footnote 133. H Rep No 841 (Conf), 99th Cong, 2d Sess, Part II-65 (1986).

(n11)Footnote 134. IRC § 46(f)(1)-(3).

(n12)Footnote 135. "Useful life," for this purpose, is the period of time over which regulatory depreciation expense is taken, as opposed to the life used for determining depreciation expense for federal income tax purposes. S Rep No 92-437, 92d Cong, 1st Sess, 39 (1971). See discussion of "ratable methods" at § 9.07[3].

(n13)Footnote 136. Treas Reg § 1.46-6(a)(4). Rules relating to the application of the elections are set forth in Treas Reg § 1.46-6(h). The manner of making the elections is set forth in Temp Treas Reg § 12.3.

(n14)Footnote 137. Treas Reg § 1.46-6(h)(1)(ii).

(n15)Footnote 138. IRC § 46(f)(1)(B).

(n16)Footnote 139. IRC § 46(f)(6).

(n17)Footnote 140. This election was required to be made by March 9, 1972. IRC § 46(f)(1).

(n18)Footnote 141. Treas Reg § 1.46-6(h)(1)(iii).

(n19)Footnote 142. S Rep 92-437, 92d Cong, 1st Sess, 37 (1971).

(n20)Footnote 143. S Rep No 92-437, 92d Cong, 1st Sess, 36 (1971). The short supply election was aimed principally at concern over the nation's existing natural gas reserves. The Federal Power Commission issued a short supply determination (see Treas Reg § 1.46-6(c)(4)) regarding natural gas in early 1972. See FPC Statement of Policy, Order No 448, Dkt No R-436, 37 F Treas Reg 2503 (Feb 2, 1972).

(n21)Footnote 144. Treas Reg § 1.46-6(b)(1)(ii).

(n22)Footnote 145. A short supply determination is a determination that the natural domestic supply of gas or steam is insufficient to meet the present and future demands of the domestic economy and is published in the Federal Register. Treas Reg § 1.46-6(c)(4). A short supply determination is considered to be in effect at any time before it is revoked. A short supply determination made after June 18, 1979, however, is not considered effective for purposes of IRC § 46(f) for property placed in service before the determination is made. Treas Reg § 1.46-6(c)(4), (5). See N 143, above.

(n23)Footnote 146. Treas Reg § 1.46-6(c)(3).

(n24)Footnote 147. The election of Option 2 had to be made by March 9, 1972. IRC § 46(f)(2).

(n25)Footnote 148. Treas Reg § 1.46-6(h)(1).

(n26)Footnote 149. IRC § 46(f)(6). See discussion in § 9.08[4].

(n27)Footnote 150. Treas Reg § 1.46-6(g)(2). See also, Ltr Ruls 8414013 and 8438029 and discussion of ratable methods in § 9.07 [3]. See also discussion of

phase-in plans at § 9.08[4].

(n28)Footnote 151. IRC § 46(f)(2)(A).

(n29)Footnote 152. See Summary of Senate Amendments to HR 10947, Joint Committee on Taxation, Nov 29, 1971.

(n30)Footnote 153. TD 8089, 1986-2 CB 6 .

(n31)Footnote 154. Former IRC § 167(l)(2)(C). See Ch 8 for a discussion of public utility property eligible under former IRC § 167(l) for the flow-through method of accounting for accelerated tax depreciation.

(n32)Footnote 155. IRC § 46(f)(8).

(n33)Footnote 156. Generally, three years from the date the return is filed for the tax year. IRC § 6501(a).

(n34)Footnote 157. See Treas Reg § 1.46-6(j).

(n35)Footnote 158. See S Rep No 92-437, 92d Cong, 1st Sess, 41 (1971).

(n36)Footnote 158.1. 1987-2 C.B. 389, Notice 87-82 .

(n37)Footnote 159. IRC § 46(f)(4)(A). See S Rep No 92-437, 92d Cong, 1st Sess, 40-41 (1971).

(n38)Footnote 160. Treas Reg § 1.46-6(f)(3).

(n39)Footnote 161. Treas Reg § 1.46-6(f)(3).

(n40)Footnote 162. S Rep No 92-437, 92d Cong, 1st Sess, 40-41 (1971).

(n41)Footnote 163. Treas Reg § 1.46-6(f)(5).

(n42)Footnote 164. Treas Reg § 1.46-6(f)(4)(ii).

(n43)Footnote 165. Treas Reg § 1.46-6(f)(9).

(n44)Footnote 166. A regulatory body is described in IRC § 46(c)(3)(B) and refers to a state or political subdivision thereof, an agency or instrumentality of the US, or by a public service or public utility commission or similar body of any state or political subdivision thereof.

(n45)Footnote 167. Treas Reg § 1.46-6(f)(7).

(n46)Footnote 168. S Rep No 92-437, 92d Cong, 1st Sess, 40 (1971); Treas Reg § 1.46-6(f)(7).

(n47)Footnote 169. Treas Reg § 1.46-6(f)(8)(i).

(n48)Footnote 170. Treas Reg § 1.46-6(f)(8)(ii).

(n49)Footnote 171. Treas Reg § 1.46-6(f)(8)(iii).

(n50)Footnote 172. Treas Reg § 1.46-6(f)(8)(iv).

(n51)Footnote 173. Treas Reg § 1.46-6(j)(1).

(n52)Footnote 174. Treas Reg § 1.46-6(f)(6).

(n53)Footnote 175. Treas Reg § 1.46-6(f)(10), Ex 1.

(n54)Footnote 176. Treas Reg § 1.46-6(c)(10), Ex 3.

(n55)Footnote 177. Pub L No 99-514, 99th Cong, 2d Sess, § 211(b) (1986):

"(b) Normalization Rules.--If, for any taxable year beginning after Dec 31, 1985, the requirements of Paragraph (1) or (2) IRC § 46(f) of the Internal Revenue Code of 1986 are not met with respect to public utility property to which the regular percentage applied for purposes of determining the amount of the investment tax credit:

> ""(1) all credits for open taxable years as of the time of the final determination referred to in IRC Section 46(f)(4)(A) of such Code shall be recaptured; and""(2) if the amount of the taxpayer's unamortized credits (or the credits not previously restored to rate base) with respect to such property (whether or not for open years) exceeds the amount referred to in Paragraph (1), the taxpayer's tax for the taxable year shall be increased by the amount of such excess."
>
> If any portion of the excess described in P (2) is attributable to a credit which is allowable as a carryover to a taxable year beginning after Dec 31, 1985, in lieu of applying P (2) with respect to such portion, the amount of such carryover shall be reduced by the amount of such portion. Rules similar to the rules of this subsection shall apply in the case of any property with respect to which the requirements of IRC § 46(f)(9) of such Code are met. See also, H Rep No 841 (Conf), 99th Cong, 2d Sess, Part II-65 (1986).

(n56)Footnote 178. The additional credit allowable for employer contributions to a TRASOP and the related normalization rules are discussed in § 9.06 [3].

(n57)Footnote 179. Highway Revenue Act of 1982, Pub L No 97-424, § 541 (1983).

(n58)Footnote 180. Cal PUC Dec 87838 (1977), 15.

(n59)Footnote 181. Cal PUC Dec 87838 (1977), 15. See also, Ltr Rul 7843065 .

(n60)Footnote 182. Ltr Rul 7843065 .

(n61)Footnote 183. Pub L No 97-424, § 541 (1983), IRC § 46(f)(10) and *amending* IRC § 168(e)(3)(C). Special transitional rules provided for a settlement reportedly limiting the liability of PT&T and GTE to approximately $321 million and $90 million, respectively. See Telecommunication Reports, Vol 49, No 1 (Jan 10, 1983), 26.

(n62)Footnote 184. [Reserved]

(n63)Footnote 185. IRC § 168(e)(3)(C), *redesignated* IRC § 168(i)(9)(B) by Pub L No 99-514, § 201(a) (1986).

(n64) Footnote 186. Former IRC § 167(l)(3)(G), *as amended by* Pub L 97-424 (1983). IRC § 167(l) was repealed as "deadwood" by Pub L No 101-508, 101st Cong, 2d Sess § 11812(a) (1990), but it remains in effect for property placed in service before Nov 6, 1990, and for certain transition property.