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Missouri Public
Service Commission

Exhibit No.:
Issues: AAO
AFUDC Rate
Phase-in Calculation
Deferred Income Taxes
Premature Retirement
Witness: James E. Salser
Exhibit Type: Rebuttal
Sponsoring Party: Missouri-American Water Company
Case No.: WR-2000-281
SR-2000-282
Date: May 4, 2000

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2000-281

CASE NO. SR-2000-282

REBUTTAL TESTIMONY

OF

JAMES E. SALSER

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

JEFFERSON CITY, MISSOURI

FILED³

MAY 04 2000

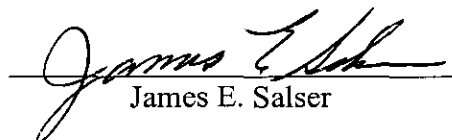
Missouri Public
Service Commission

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN)	
WATER COMPANY FOR AUTHORITY TO)	
FILE TARIFFS REFLECTING INCREASED RATES)	CASE NO. WR-2000-281
FOR WATER AND SEWER SERVICE IN THE)	CASE NO. SR-2000-282
MISSOURI SERVICE AREA OF THE COMPANY)	

AFFIDAVIT OF JAMES E. SALSER

James E. Salser, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of James E. Salser"; that said testimony and schedules were prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge.


James E. Salser

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
before me this 3rd day of May 2000.


Notary Public, Sharon K. Lee

My commission expires:

SHARON K. LEE, NOTARY PUBLIC
STATE OF MISSOURI, ST. LOUIS COUNTY
MY COMMISSION EXPIRES FEBRUARY 21, 2003

**REBUTTAL TESTIMONY
JAMES E. SALSER
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2000-281
CASE NO. SR-2000-282**

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WITNESS INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND EMPLOYER.

A. My name is James E Salser, by business address is Box 157AA Route 2 Ravenswood, WV 26164 and I am self-employed.

Q. ARE YOU THE SAME JAMES E. SALSER THAT PREVIOUSLY FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony will address: 1) Office of the Public Counsel ("OPC") witness Trippensee's direct testimony regarding the Accounting Authority Order (AAO) being requested by MAWC; 2) Missouri Public Service Commission Staff ("Staff") witnesses Rackers' proposed adjustment to the AFUDC rate MAWC has used since the Company's last rate order and the calculation of Mr. Rackers' revenue requirement increase phase-in methodology associated with the St. Joseph Treatment Project; 3) Staff witness Gibbs' rate base adjustments to include pre-merger Missouri-Cities' deferred income taxes; and 4) OPC witness Bolin's testimony related to the retirement of the existing St. Joseph treatment plant.

ACCOUNTING AUTHORITY ORDER

Q. OPC WITNESS TRIPPENSEE STATES ON PAGE 4 OF HIS DIRECT TESTIMONY THAT "THE COMPANY'S ACCOUNTING AUTHORITY

1 **ORDER REQUEST IS AN ATTEMPT TO INSULATE ITS**
2 **SHAREHOLDERS FROM REGULATORY LAG.” IS THIS TRUE?**

3 A. Yes.

4 **Q. IS THIS A PROPER PURPOSE FOR AN ACCOUNTING AUTHORITY**
5 **ORDER?**

6 A. Yes. As pointed out by OPC witness Trippensee, the Commission, as well as the
7 Missouri Court of Appeals, have previously recognized that in certain
8 circumstances it is appropriate to defer expenditures from one rate period for
9 recovery in a later period.

10 **Q. DOES MAWC BELIEVE THAT CIRCUMSTANCES IN THIS CASE**
11 **WARRANT AUTHORIZING MAWC TO CONTINUE THE**
12 **CAPITALIZATION OF AFUDC AND TO DEFER THE ACCRUAL OF**
13 **DEPRECIATION EXPENSE ON THE ST. JOSEPH TREATMENT PLANT**
14 **AND RELATED FACILITIES FROM THE IN-SERVICE DATE UNTIL**
15 **THE EFFECTIVE DATE OF A COMMISSION RATE ORDER WHICH**
16 **INCLUDES THE ST. JOSEPH TREATMENT PLANT AND RELATED**
17 **FACILITIES IN MAWC’S RATE BASE AND INCLUDES**
18 **DEPRECIATION EXPENSE IN MAWC’S OPERATING EXPENSES?**

19 A. Yes. The construction of the St. Joseph treatment plant and related facilities,
20 which includes a change in the source of supply, is not a typical and customary
21 business activity in either cost or circumstances.

22 **Q. WERE THERE EXTRAORDINARY FACTORS THAT LEAD TO THIS**
23 **DECISION?**

1 A. Yes. As was examined in detail in Commission Case No. WA-97-46, this
2 construction resulted from factors that the Commission has indicated are
3 appropriate bases for AAOs. The testimony in Case No. WA-97-46 revealed that
4 there were capacity, reliability, process control and safety deficiencies with the
5 existing St. Joseph treatment plant (which is over 100 years old) that made it
6 necessary to take the dramatic steps of changing the source of supply and
7 construction of a treatment plant at a new location. Both extreme low water on
8 the river and extreme high water (flooding) had left the City of St. Joseph without
9 water twice within the last decade (Acts of God). While improvements had been
10 made to temporarily address this problem, the only real solution was to move the
11 treatment plant out of the flood plain and eliminate the river as a source of supply.
12 Additionally, increased regulatory requirements enacted by Congress and
13 implemented by the Environmental Protection Agency and the Missouri
14 Department of Natural Resources relating to the treatment of the water drove this
15 construction. These regulations were man-made decisions that are resulting in
16 extraordinarily changed conditions for water utilities, and are similar in effect to
17 the gas safety rules which have lead to AAOs in the natural gas industry. These
18 factors are examined in greater detail in the rebuttal testimony of Company
19 witness John Young.

20 **Q. HAS MAWC ASKED FOR THIS TREATMENT OF AFUDC AND**
21 **DEFERRED DEPRECIATION AS TO ALL CAPITAL PROJECTS THAT**
22 **HAVE BEEN PLACED IN-SERVICE SINCE MAWC'S LAST RATE**
23 **CASE?**

1 A. No. MAWC has only asked for this treatment as to the St. Joseph treatment plant
2 project and related facilities.

3 **Q. WHY?**

4 A. The St. Joseph treatment plant project has a very serious financial impact on
5 MAWC which warrants this unusual accounting treatment.

6 **Q. CAN YOU QUANTIFY THE IMPACT RELATED TO THE POST-IN-
7 SERVICE AFUDC AND THE DEFERRED DEPRECIATION ISSUE?**

8 A. Yes. The discontinuance of the capitalization of AFUDC and the commencement
9 of depreciation on the St. Joseph treatment plant and related facilities prior to a
10 rate order which includes this project reduces MAWC's earnings approximately
11 \$319,000 each month (as reflected on Revised Schedule JES-2R) the St. Joseph
12 treatment plant is "in service" and not included in rates. Over the approximate
13 four and one-half months between the expected "in service" date and the
14 operation of law date, this amounts to a loss to the Company of \$1.6 million.
15 Additionally, the post-in-service AFUDC and deferred depreciation expense net
16 of taxes represents over twenty-four percent (24%) of MAWC's pro forma utility
17 operating income at present rates. Pro forma present rate earnings for the period
18 May through August 2000, is projected to result in a return on common equity of
19 4.22% without consideration for post-in-service AFUDC and deferred
20 depreciation expense. These earnings would be even lower if the period was
21 something other than the summer months. Earnings for the same period under the
22 proposed rates would be \$3,758,000.

1 **Q. DOES THIS TYPE OF FINANCIAL IMPACT HAVE A CONSEQUENCE**
2 **FOR MAWC’S CUSTOMERS?**

3 A. Yes. The interest of MAWC’s customers is served by the improvements to the
4 utility systems from which they receive service and a sound financial base.
5 Forcing a utility to suffer losses of the size indicated in the absence of the
6 requested ratemaking treatment is a huge disincentive for investment in water
7 systems, as well as other utility systems in the State of Missouri.

8 **AFUDC RATE**

9 **Q. PLEASE DESCRIBE STAFF WITNESS RACKERS’ PROPOSED AFUDC**
10 **ADJUSTMENT.**

11 A. Mr. Rackers has made a \$ 1,257, 930 adjustment to the recording of AFUDC
12 since the last rate case order to the St. Joseph Treatment Plant account. On page
13 13, line 14 of Mr. Rackers’ Direct Testimony, he has recommend that the
14 Commission order MAWC to adjust the AFUDC rate it has used since the
15 effective date of the rates in the last case.

16 **Q. WHAT RATE HAS MAWC USED DURING THIS TIME PERIOD?**

17 A. MAWC has utilized the rate of return on rate base authorized in its most recent
18 rate case for its AFUDC rate.

19 **Q. HOW LONG HAS MAWC OR THE AMERICAN WATER WORKS**
20 **SYSTEM USED THIS RATE?**

21 A. MAWC has taken this approach for at least the last thirty years.

1 **Q. WHAT AFUDC RATE HAS BEEN USED BY THE COMMISSION IN**
2 **PAST MAWC RATE CASES?**

3 A. The Company has used the rate of return on rate base without any comment from
4 the Commission Staff in past rate cases.

5 **Q. WHAT IS MR. RACKERS' BASIS FOR THIS ADJUSTMENT?**

6 A. He suggests that the AFUDC rate should include the rate associated with short
7 term debt outstanding. Outstanding construction work in progress over the
8 amount of short term debt would receive the overall rate of return.

9 **Q. WHAT WOULD BE THE RATE OF RETURN ON EQUITY IF MR.**
10 **RACKERS' ADJUSTMENT WERE APPROVED BY THE**
11 **COMMISSION?**

12 A. If adopted by the Commission, the Company would be required to record this
13 adjustment in the month of September 2000 and it would result in a write-off of
14 \$1,257,930 and a return of 3.67% on the common equity for the five month period
15 ended September 2000.

16 **Q. WHEN DID MAWC BEGIN USING THE AFUDC RATE WHICH MR.**
17 **RACKERS SEEKS TO ADJUST?**

18 A. November 1997.

19 **Q. HAS THE COMPANY RELIED UPON THE USE OF THE AUTHORIZED**
20 **RATE OF RETURN AS THE AFUDC RATE?**

21 A. Yes. The Company included the AFUDC funds in its most recent financing of
22 \$29,000,000 tax-exempt to determine the historical interest coverage calculation.

1 **Q. IF THE COMMISSION SHOULD DETERMINE THAT IT IS NOT**
2 **APPROPRIATE TO UTILIZE THE AUTHORIZED RATE OF RETURN**
3 **AS THE AFUDC RATE, WHEN SHOULD THE CHANGE BE MADE?**

4 A. It is not reasonable for the Commission to now order a write off of \$1,257,930 to
5 MAWC's Income Statement for AFUDC recorded during the period November
6 14, 1997 through September 14, 2000. If the Commission decides the AFUDC
7 rate should change, it should do it only on a going forward basis.

8 **PHASE-IN PLAN**

9 **Q. MR. SALSER HAVE YOU REVIEWED THE CALCULATIONS**
10 **RELATED TO MR. RACKERS' RATE INCREASE PHASE-IN PLAN?**

11 A. Yes I have.

12 **Q. DO YOU HAVE ANY CONCERNS WITH THE CALCULATIONS**
13 **RELATED TO MR. RACKERS' RATE INCREASE PHASE-IN PLAN.**

14 A. Yes. In reviewing Mr. Rackers' rate increase phase-in calculations, it appears to
15 me that one-half of the annual depreciation expense has been included in the first
16 years' calculation to determine the rate base. It is my opinion that one-half of the
17 first years' net phase-in deferred balance should also be included in the first years'
18 rate base.

19 **Q. PLEASE EXPLAIN WHY THIS IS APPROPRIATE.**

20 A. It is the same theory as the depreciation expense being deducted. It has been
21 accumulated over a full year. However, it must be averaged over the year because
22 we are only addressing a partial year. Thus, the net phase-in deferred balance

1 should be added to the first years' rate base. This is also true of the first four
2 years in Mr. Rackers five year rate increase Phase-in Plan.

3 **DEFERRED INCOME TAXES ASSOCIATED WITH MISSOURI-CITIES**
4 **PROPERTY**

5 Q. STAFF WITNESS GIBBS HAS INCLUDED THE DEFERRED INCOME
6 TAXES RELATED TO MISSOURI CITIES PRIOR TO ITS
7 ACQUISITION WITH MAWC AS A DEDUCTION IN HIS RATE BASE
8 CALCULATION. DO YOU AGREE WITH THIS DEDUCTION?

9 A. No.

10 Q. PLEASE DESCRIBE THE BASIS FOR THESE DEFERRED TAXES.

11 A. The deferred income taxes are based upon: 1) deferred taxes from the difference
12 between book and tax basis property for depreciation; and, 2) the investment tax
13 credit (ITC). The ITC was created by Missouri Cities' investment in utility plant.

14 Q. WHY DO YOU NOT AGREE WITH MR. GIBBS' ADJUSTMENT?

15 A. Past actions of the Commission have indicated that this is not an issue. Also,
16 Internal Revenue Service rules indicate that this should not be an issue.

17 Q. TO WHAT PAST ACTIONS OF THE COMMISSION DO YOU REFER?

18 A. First, MAWC did not acquire these deferred taxes as a part of the Missouri Cities
19 acquisition. This was a part of the agreement that was approved by the
20 Commission. Second, since the acquisition of Missouri Cities, and its subsequent
21 merger with MAWC, MAWC has completed two rate cases in which these
22 deferred taxes were not an issue.

1 **Q. TO WHAT INTERNAL REVENUE SERVICE RULES DO YOU REFER?**

2 A. First, reducing the Company's rate base for the Missouri-Cities accumulated
3 investment tax credit deferred would be inconsistent with Section 46(f) of the
4 Internal Revenue Code. It also would violate the consistency rules of Section
5 46(f)10 and would violate the normalization requirement of Section 46(f)(2).
6 Second, a reduction in the new Company's rate base for accumulated deferred
7 federal income taxes attributable to accelerated depreciation would violate the
8 Section 168(i)9 normalization requirements. The deferred tax reserve is deemed
9 to cease to exist as to the asset sale because the assets are considered retired under
10 Treas. Reg. 1.167(i)-1(h)(2)(i). Additionally, the deferred taxes have been paid to
11 the Internal Revenue Service by the seller. A copy of a letter ruling discussing
12 these sections is attached as Schedule JES-1.

13 **PREMATURE RETIREMENT**

14 **Q. OPC WITNESS BOLIN, ON PAGES 2-5 OF HER DIRECT TESTIMONY,**
15 **DISCUSSES THE RETIREMENT OF THE EXISTING ST. JOSEPH**
16 **TREATMENT PLANT. PLEASE EXPLAIN THE BACKGROUND OF**
17 **THIS ISSUE.**

18 A. As is discussed in the testimony of Company Witness Young, MAWC has
19 constructed a new St. Joseph treatment plant and related facilities. Because the
20 existing treatment plant was not fully depreciated at the time it was taken out of
21 service, a depreciation reserve was created for the remaining value of the plant.

1 MAWC believes a depreciation study should be created to address the effects of
2 the plant being retired.

3 **Q. WHAT DOES MAWC BELIEVE IS THE MOST APPROPRIATE WAY**
4 **TO ADDRESS THIS ADJUSTMENT?**

5 A. The retirement of the existing St. Joseph treatment plant should be recorded as
6 any other retirement and it will be a part of the Company's next depreciation study
7 that will be completed with the Company's next rate case.

8 **Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?**

9 A. Yes, it does.

Letter Rulings/TAMS, Letter Ruling 9418004

Letter Ruling 9418004, January 14, 1994

CCH IRS Letter Rulings Report No. 897, 05-11-94

IRS REF: Symbol: CC:DOM:P&SI:Br.6-TR-31-1745-93

Uniform-Issue List Information:

UIL No. 0046.06-07

UIL No. 0168.24-01

[Code Secs. 46 and 168]

This letter responds to your representative's letter of July 8, 1993, requesting rulings by Taxpayer on behalf of Target with respect to the proper treatment of Target's accumulated deferred investment tax credits ("ADITC's") under section 46(f)(2) of the Internal Revenue Code and accumulated deferred federal income taxes ("ADFIT's") under section 168(i)(9), subsequent to an election under section 338(h)(10).

Taxpayer represents that the facts are as follows:

Taxpayer is the parent company of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting. Taxpayer is a regulated public utility company engaged in the business of providing telecommunications services through local exchange telephone operations and mobile cellular communications operations.

On Acquisition Date, Taxpayer acquired all of the common stock of Target from Seller, an unrelated communications company. Following the acquisition, Target will join in the filing of the consolidated federal income tax return of Taxpayer. Target is a public utility engaged in the business of providing telephone services and is subject to regulation by Commission A and Commission B.

Taxpayer and Seller made a timely joint election under section 338(h)(10) of the Code for Target. As a result, the purchase of Target's stock is created as a purchase of Target's assets for federal income tax purposes.

For financial and regulatory purposes, the basis of Target's assets after the stock purchase will have the same basis as Target had prior to the stock purchase.

Before Acquisition Date, Target had claimed both investment credits and accelerated depreciation deductions on its public utility property. For purposes of the investment credit normalization rules under section 46(f) of the Code, Target has elected to be treated under section 46(f)(2). At the time of the acquisition, Target had recorded on its books ADITC's totalling x dollars (net of recapture resulting from the section 338(h)(10) election) and ADFIT's totalling y dollars attributable to public utility property.

Because Taxpayer is concerned about the effect of a section 338(h)(10) election on the proper treatment of the x dollars in the ADITC account and the

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Continued Page 2

dollars in the ADFIT account under the provisions of sections 46(f)(2) and 168(i)(9) of the Code, respectively, Taxpayer seeks the following rulings:

1. For any period subsequent to Acquisition Date, whether a reduction to Target's tax expense used to determine cost of service for ratemaking purposes for unamortized and unrecaptured ADITC attributable to investment credits on public utility property claimed before Acquisition Date would violate the provisions of section 46(f)(2) of the Code?

2. Whether the transfer of the unamortized and unrecaptured ADITC to an equity account of Target would violate the normalization requirements of section 46(f)(2) of the Code?

3. For any period subsequent to Acquisition Date, whether a reduction to Target's rate base for ADFIT attributable to accelerated depreciation on public utility property claimed prior to Acquisition Date would violate the provisions of section 166(i)(9) of the Code?

Taxpayer's ruling requests depend upon the effect of a section 338(h)(10) election on the investment credits and accelerated depreciation deductions associated with Target's public utility property.

Section 338(a) of the Code provides that, if the stock of a corporation ("target corporation") is acquired by another corporation ("purchasing corporation") in a qualified stock purchase, the purchasing corporation may elect to have the purchase of the target corporation's stock treated as if the target corporation sold all of its assets (as "old target") at the close of the acquisition date at fair market value in a single transaction. The target corporation then is treated as a new corporation that purchased those same assets (as "new target") as of the beginning of the day after the acquisition date.

If, before the stock purchase, the target corporation is a member of an affiliated group that files a consolidated return for the tax year within which the transaction takes place, section 338(h)(10) of the Code provides an election under which recapture and other tax liability of the target corporation from the deemed sale of its assets is included in the consolidated return of the selling consolidated group ("selling group"). This election is made jointly by the purchasing corporation and the selling group pursuant to section 1.338(h)(10)-1T(d)(1) of the temporary Income Tax Regulations.

The consequences of a section 338(h)(10) election are provided in section 1.338(h)(10)-1T(e) of the temporary regulations. Under section 1.338(h)(10)-1T(e)(1), old target recognizes gain or loss as if, while a member of the selling group, it sold all of its assets in a single transaction as of the close of the acquisition date. Section 1.338(h)(10)-1T(e)(3) further provides that, at the close of the acquisition date but after the deemed sale of assets, old target is treated as if it distributed all of its assets in a complete liquidation to which section 332 of the Code applies. Thus, the primary effect of a section 338(h)(10) election is a deemed taxable sale by target corporation of all its assets followed by a deemed complete liquidation

and section 332.

In addition, section 1.338(h)(10)-1T(e)(2) of the temporary regulations provides that, for purposes of Chapter 1 of the Code, gain or loss is ignored on the actual sale or exchange by the selling group to the purchasing corporation of target corporation's stock included in a qualified stock purchase.

Under section 1.338(h)(10)-1T(e)(7)(ii), any investment credit property deemed sold by old target on the close of the acquisition date may be subject to recapture under section 47(a) of the Code. Any increase in tax resulting from the recapture of old target's investment credit is added to the tax liability of the selling group for the tax period that includes the acquisition date.

As to the consequences of a section 338(h)(10) election on new target, section 1.338(h)(10)-1T(e)(6) of the temporary regulations determines the adjusted gross-up basis ("AGUB") for target corporation. The AGUB is the total amount for which new target is deemed to have purchased all of its assets. The AGUB is allocated among the assets of new target.

In general, the AGUB is the sum of (1) the purchasing corporation's grossed-up basis in recently purchased stock of target corporation, (2) the basis of the purchasing corporation's nonrecently purchased stock of target corporation, (3) the liabilities of new target as of the beginning of the day after the acquisition date (other than liabilities that were not liabilities of old target), and (4) other relevant items. Under section 338(b)(4) of the Code and section 1.338-4T(j)(2) of the temporary regulations, the purchasing corporation's grossed-up basis of recently purchased stock of target corporation is the basis of the purchasing corporation in recently purchased stock of target corporation, multiplied by a fraction whose numerator is 100 percent minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock and whose denominator is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.

In addition, section 1.338(h)(10)-1T(e)(8)(ii) of the temporary regulations provides that section 1.338-4T(1), which covers certain matters affecting new target, is applicable to a section 338(h)(10) election. In accordance with section 1.338-4T(1)(2), new target is entitled to the investment credit for property it is deemed to purchase under section 338 of the Code, provided the property would qualify for the investment credit if new target acquired it in an actual purchase.

Further, section 1.338-4T(1)(2) of the temporary regulations provides that new target generally is permitted to take depreciation deductions under section 168 of the Code on depreciable property acquired in the deemed purchase of assets and may make new elections under section 168 without regard to the elections made by old target. For purposes of the anti-churning rule of section 168(f)(5) (former section 168(e)(4)) and the rule in section 168(i)(7)

(f. per section 166(f)(10)) under which the transferee of property is treated as the transferor in certain cases, old target is not a related person with respect to new target.

In the present situation, Taxpayer purchased all of the common stock of Target, and Taxpayer and Seller made a joint election under section 338(h)(10) of the Code for Target. This election results, for federal income tax purposes, in a deemed taxable sale of assets by Target (as "old Target") in a single transaction as of the close of Acquisition Date. Consequently, gain or loss on this deemed sale is recognized by old Target, and any unearned investment credits of old Target are recaptured.

Further, Target is treated as a new corporation that purchased those same assets (as "new Target") on the day after Acquisition Date. The basis of old Target's assets do not carryover to new Target. Instead, new Target receives a new tax basis in the assets deemed purchased from old Target. Because the anti-churning rules of section 168(f)(5) and the transferor-transferee rules under section 168(i)(7) do not apply to new Target, it does not "step into the shoes" of old Target for depreciation purposes. Therefore, new Target is entitled to deduct depreciation on the new tax basis and receives the benefit of a new placed in service date for the assets deemed purchased. Moreover, new Target is entitled to claim investment credit, if available, on the new tax basis.

Thus, as a result of the section 338(h)(10) election, the purchase of Target's stock by Taxpayer is treated for federal income tax purposes as a purchase of Target's assets in a taxable transaction. Consequently, the investment credits and accelerated depreciation deductions attributed to old Target's public utility property do not carryover from old Target to new Target. Thus, the ADITC's of x dollars and the ADFIT's of y dollars related to that property do not follow the assets.

Issue No. 1

Target has elected to account for the investment credit on public utility property in accordance with section 46(f)(2) of the Code. This section provides that no investment credit determined under section 46(a) shall be allowed by section 38 with respect to any public utility property of the taxpayer (a) if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the investment credit, or (b) if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the investment credit.

Section 1.46-6(a)(3) of the regulations provides that the provisions of section 46(f)(2) of the Code are limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. If an election is made under section 46(f)(2), the credit may be flowed through to income, but not more rapidly than ratably, and there may not be any reduction in rate base.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Under section 1.46-6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense" means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

Section 46(f)(7) of the Code provides that if by reason of a corporate reorganization or by reason of any other acquisition of the assets of one taxpayer by another taxpayer, the application of any provisions of section 46(f) to any public utility property does not carry out the purposes of section 46(f), the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of section 46(f).

According to section 46(f)(10)(A) of the Code, one way in which the requirements of section 46(f)(2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under section 46(f)(10)(B), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's qualified investment for purposes of the investment credit allowable by section 38 unless such estimate or projection is also used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

Any public utility that claims the investment credit for public utility property must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. Under normalization accounting, the immediate flow-through of the investment credit for public utility property to the utility's customers is prohibited. Instead, under section 46(f)(2) of the Code, for ratemaking purposes the utility defers the investment credit it claimed for Federal income tax purposes and then amortizes the deferred balance ratably over the regulatory life of the assets generating the credit.

Taxpayer's first ruling request involves the treatment of the ADITC's not subject to recapture upon the deemed sale of Target's public utility property under a section 338(h)(10) election.

In a taxable sale of assets, the purchaser does not "step into the shoes" of the seller and as a result, any investment credit associated with the assets do not carryover from the seller to the purchaser. Instead, the purchaser receives the benefit of a new tax basis in, and a new placed in service date for, the property. This new basis and placed in service date determine the availability and the amount of the investment credit that the purchaser may claim for the acquired property. Except for certain transition property, property placed in service by a taxpayer after 1985 is not eligible for the investment credit.

In the present situation, Taxpayer acquired the common stock of Target, and Taxpayer and Seller made a joint election under section 338(h)(10) of the Code for Target. This election results, for federal income tax purposes, in a deemed taxable sale of assets by old Target to new Target. New Target does not step into the shoes of old Target. Instead, new Target receives a new tax basis in, and a new placed in service date for, the assets deemed purchased from old Target. Consequently, the unamortized and unrecaptured ADITC's associated with old Target's public utility property do not follow the property. Thus, these ADITC's are not available to new Target for flow through to its customers.

Further, new Target is not entitled to claim the investment credit for the property deemed purchased from old Target because the property is placed in service by new Target after 1985. Therefore, for such property, there is no investment credit claimed by new Target to reduce cost of service under section 46(f)(2) of the Code.

The normalization rules under section 46(f) of the Code contemplate that the utility may claim the investment credit for public utility property. Further, the legislative purpose underlying section 46(f) was to provide capital for investment in new equipment. If the ADITC's related to old Target's public utility property are ratably flowed through to cost of service, new Target would be flowing through to its customers an investment credit that is not available to, and was not claimed by, it. Consequently, new Target would receive no tax benefits of the investment credit while its customers would. Accordingly, an adjustment to cost of service for the ADITC's of old Target would not be consistent with the purposes of section 46(f).

Further, the adjustment to cost of service for the ADITC's associated with old Target's public utility property would violate the consistency rules under section 46(f)(10) of the Code. Such an adjustment assumes that the qualified investment of new Target for purposes of the investment credit allowable under section 38 is equal to old Target's qualified investment. However, section 46(f)(10)(B) clearly states that the taxpayer's qualified investment must be used. In the present situation, the taxpayer is new Target. Because the investment credit has been repealed, none of the public utility property placed in service by new Target is eligible for the credit and consequently, its qualified investment is zero. Thus, an adjustment to the cost of service of new Target for the ADITC's of old Target would violate the normalization requirements of section 46(f)(2).

Issue No. 2

Taxpayer's second ruling request relates to the transfer of the unamortized and unrecaptured ADITC's of x dollars to an equity account of Target. The effect of this accounting treatment is to flow through old Target's investment credit immediately to new Target's shareholder who is Taxpayer.

The normalization rules of section 46(f)(2) of the Code do not require public utility commissions to take investment credit on public utility

property into account in determining cost of service, but does permit them to do so provided the reduction to cost of service is by no more than a ratable portion of the credit.

- As determined under this ruling, the flow through of the unamortized and unrecaptured ADITC's of old Target to new Target's customers would violate the normalization requirements of section 46(f)(2) of the Code. By transferring the ADITC's of old Target to an equity account of new Target, this transferred amount will not be available to reduce cost of service and rate base in setting future rates and, as a result, the ADITC's of old Target would not be flowed through to new Target's customers. Thus, the normalization requirements of section 46(f)(2) of the Code are satisfied. The fact that the accounting for the ADITC's of old Target will be for the benefit of Target's shareholder who is Taxpayer is outside the scope of section 46(f).

Issue No. 3

Taxpayer's third ruling request involves the treatment of the unamortized ADITC's upon the deemed sale of Target's public utility property under a section 338(h)(10) election.

- Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 169 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 no 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 167(l) of the Code generally provides that public utilities are entitled to use accelerated methods of depreciation if they use a "normalization method of accounting." A normalization method of accounting is defined in section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A).

Section 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property pursuant to section 167(l) of the Code should reflect the total amount of the deferral of Federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) of the regulations 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.

Section 1.167(l)-1(h)(2)(i) of the regulations 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 the aggregate amount allocable to deferred taxes, under section 167(l) of the Code 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 under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

An election under section 338(h)(10) of the Code results in the sale of assets by old Target to new Target and the recognition of gain or loss upon such sale by old Target. Because of this sale, old Target's deferred tax reserve relating to accelerated depreciation is reduced under section 1.167(l)-1(h)(2)(i) of the regulations to reflect the retirements of old Target's assets. After the application of section 1.167(l)-1(h)(2)(i), old Target's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the deferred tax reserve resulting from accelerated depreciation should be removed from old Target's regulated books of account and not flowed through to the customers of new Target.

Based on Taxpayer's representations and the analysis as set forth above, we conclude as follows:

1. For any period subsequent to Acquisition Date, Target will violate the normalization requirements of section 46(f)(2) of the Code if Target's cost of service is reduced for the amortization of any portion of the unamortized and unrecaptured ADITC's attributable to investment credits on public utility property claimed before Acquisition Date.

2. The transfer to an equity account of Target of the unamortized and unrecaptured ADITC's attributable to investment credits on public utility property claimed before Acquisition Date will not violate the normalization requirements of section 46(f)(2) of the Code.

3. The unamortized ADFIT's related to accelerated depreciation on public utility property claimed by Target prior to Acquisition Date are eliminated upon the deemed sale of Target's assets under section 338(h)(10) of the Code. Thus, for any period subsequent to Acquisition Date, Target will violate the normalization requirements of section 168(i)(9) if Target's rate base is reduced for the unamortized ADFIT's attributable to accelerated depreciation on public utility property claimed before Acquisition Date.

No opinion is expressed concerning whether the section 338(h)(10) election made by Taxpayer and Seller for Target is a valid election.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representative.

Sincerely yours, Charles B. Ramsey, Chief, Branch 6, Office of Assistant Chief Counsel (Passthroughs and Special Industries)