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Surcharge  
Witness: John R. Wilde  
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Case No.: WO-2018-0059  
Date: November 20, 2017

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WO-2018-0059**

**DIRECT TESTIMONY**

**OF**

**JOHN R. WILDE**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

**DIRECT TESTIMONY  
JOHN R. WILDE  
MISSOURI-AMERICAN WATER COMPANY  
CASE NO. WO-2018-0059**

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**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

<b>IN THE MATTER OF MISSOURI-AMERICAN ) WATER COMPANY'S PETITION TO ) ESTABLISH AN INFRASTRUCTURE ) REPLACEMENT SURCHARGE )</b>	<b>) ) ) ) )</b>	<b>CASE NO. WO-2018-0059</b>
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**AFFIDAVIT OF JOHN R. WILDE**

John R. Wilde, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Direct Testimony of John R. Wilde"; 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.

*John R Wilde*  
\_\_\_\_\_  
John R. Wilde

**State of Missouri  
County of St. Louis  
SUBSCRIBED and sworn to  
Before me this 20<sup>th</sup> day of November 2017.**

*Mary Beth Hercules*  
\_\_\_\_\_  
Notary Public

**My commission expires:**



**DIRECT TESTIMONY**

**JOHN R. WILDE**

**I. INTRODUCTION**

**Q. Please state your name and business address.**

A. My name is John R. Wilde, and my business address is 131 Woodcrest Road, Cherry Hill, New Jersey 08003.

**Q. By whom are you employed and in what capacity?**

A. I am employed by American Water Works Service Company, Inc. (“Service Company”) as Senior Director - Tax. The Service Company is a subsidiary of American Water Works Company, Inc. (“American Water”) that provides services to American Water’s subsidiaries, including Missouri-American Water Company (“MAWC”, “Missouri-American” or “Company”).

**Q. What are your duties as Senior Director - Tax?**

A. My duties include management and oversight of the corporate tax function for American Water and its subsidiaries including Missouri-American.

**Q. Please summarize your education background and professional experience.**

A. I graduated from Saint Norbert College, De Pere, Wisconsin, in 1984 with a Bachelor of Business Administration Degree in Accounting. I have a graduate certificate in state and local taxation, as well as a Master of Science Degree in Taxation from the University of Wisconsin-Milwaukee. I have over 30 years of experience as a tax and

1 accounting professional serving utilities with regulated operations in multiple states.  
2 For the fifteen years before my employment with Service Company, I was the head of  
3 the tax function for Integrys Energy Group, Inc (now part of WEC Energy Group, Inc.),  
4 a group that included six utilities with operations in four states.

5

6 **Q. Have you previously testified before this Commission or any other regulatory**  
7 **agencies?**

8 A. Yes. In addition, I have previously testified before Federal Energy Regulatory  
9 Commission (“FERC”), the Public Service Commission of Wisconsin, the Michigan  
10 Public Service Commission, the Minnesota Public Utilities Commission, the Illinois  
11 Commerce Commission, the Virginia State Corporation Commission, and the  
12 Pennsylvania Public Utility Commission.

13

14 **Q. What is the purpose of your testimony in this proceeding?**

15 A. The purpose of my testimony is to discuss the following items:

- 16 • MAWC ISRS Calculation – Provision for Income Taxes
- 17 • Staff Proposed ISRS Calculation – Provision for Income Taxes
- 18 • OPC Proposed ISRS Calculation – Provision for Income Taxes
- 19 • Income Tax - Normalization – General
- 20 • Income Taxes – Normalization – Federal Normalization Rules

21

1 **II. MAWC ISRS CALCULATION – PROVISION FOR INCOME TAXES**

2 **Q. Can you summarize MAWC’s calculation of income taxes in developing the**  
3 **revenue requirements that make up the ISRS surcharge requested by the**  
4 **company?**

5 A. Yes. Taxes are reflected in the revenue requirement in two ways. First, the revenue  
6 requirement includes a gross up on the equity return to reflect taxes the Company will  
7 have to pay on the ISRS revenues. Second, the impact of Accumulated Deferred  
8 Income Taxes are reflected as an adjustment to rate base. The temporary book / tax  
9 difference associated with accelerated and bonus tax depreciation is reflected as a  
10 Deferred Tax Liability at the applicable statutory effective rate. The Net Operating  
11 Loss, primarily generated by the accelerated and bonus tax depreciation deductions, is  
12 reflected as a Deferred Tax Asset. The net of the Deferred Tax Liability and the  
13 Deferred Tax Asset combined represent the accumulated deferred income tax (ADIT)  
14 balance related to eligible ISRS property placed in service.

15  
16 **Q. What statutory guidance or commission rule did MAWC follow in determining**  
17 **what income tax amounts should be provided for in developing the revenue**  
18 **requirements?**

19 A. Commission Rule 4 CSR 240-3.650 (Referring to Mo. Statute 393.1006), Water Utility  
20 Petitions for Infrastructure System Replacement Surcharges, sets out the PSC rules  
21 pertaining to ISRS. In part, this rule states:

22 (1) As used in this rule, the following terms mean:

23 (A) Appropriate pretax revenues—the revenues necessary to:

- 24 1. Produce net operating income equal to the eligible water utility’s weighted  
25 cost of capital multiplied by the net original cost of eligible infrastructure  
26 system replacements (original cost of eligible infrastructure  
27 system replacements, net of accumulated deferred income taxes and

- 1 accumulated depreciation associated with the replacements),
- 2 including recognition of accumulated deferred income taxes and
- 3 accumulated depreciation associated with eligible infrastructure system
- 4 replacements that are included in a currently effective ISRS;
- 5 2. Recover state, federal, and local income or excise taxes applicable to
- 6 such income; and
- 7 3. Recover all other ISRS costs;
- 8

9 The Rule states that appropriate pretax ISRS revenues are to be determined by  
10 reflecting eligible ISRS plant additions, net of accumulated depreciation and  
11 accumulated deferred income taxes, as well as the revenues necessary to recover state,  
12 federal, and local income or excise taxes applicable to such income.

13  
14 **Q. Is the statutory guidance and/or commission rule referred to by MAWC**  
15 **consistent with the tax normalization rules you referred to above?**

16 A. Yes, based on my understanding of the tax normalization rules, and my plain reading  
17 of the applicable statutory guidance and commission rule.

18  
19 **Q. Is MAWC's inclusion of income tax expense and resulting ADIT balances**  
20 **consistent with statutory guidance, commission rule, and tax normalization rules**  
21 **cited above with respect to computing the revenue requirement that represents**  
22 **the ISRS surcharge?**

23 A. Yes, based on my plain reading.

24  
25 **III. STAFF ISRS CALCULATION – PROVISION FOR INCOME TAXES**

26 **Q. What adjustment to income tax components of MAWC's ISRS calculation did**  
27 **staff make?**

1 A. Staff removed the NOL DTA, indicating that MAWC did not clearly demonstrate the  
2 NOLC DTA resulted from investments in eligible ISRS investments. Please see  
3 Schedule JRW-1 for details.

4

5 **Q. Does MAWC agree with the adjustment that Staff made to MAWC ISRS**  
6 **Surcharge calculation, and the reason Staff cited in making the adjustments.**

7 A. No, the adjustment should not be made. The NOL results solely and directly from the  
8 eligible ISRS plant investments, In addition the primary cause of the NOLC DTA is  
9 accelerated depreciation deductions including bonus, so leaving the DTL in the  
10 calculation and excluding the NOLC DTA that results from claiming those deductions  
11 is inconsistent with the tax normalization rules. 100% of the NOL DTA that is provided  
12 for in MAWC calculation is related to ISRS eligible property.

13

14 **Q. Is Staff's adjustment to MAWC's calculation consistent with relevant statutory**  
15 **guidance, commission rule, and the tax normalization rules?**

16 A. No. Staff's adjustment excludes a required cost component of the utility's eligible  
17 ISRS investment, which is the NOLC DTA component of the net ADIT balance. This  
18 is inconsistent with a plain reading of the statutory guidance and commission rule. As  
19 addressed earlier in my testimony excluding the NOL DTA is inconsistent with the tax  
20 normalization rules.

21

22 **IV. OPC ISRS CALCULATION – PROVISION FOR INCOME TAXES**

23 **Q. What adjustment to income tax components of MAWC's ISRS calculation did**  
24 **OPC make?**



1 A. OPC removed the entire provision for income taxes included by MAWC, and adjusted  
2 MAWC Weighted Average Cost of Capital. Please see Schedule JRW-1 for the details.

3

4 **Q. Does MAWC agree with the adjustments that OPC made to MAWC ISRS**  
5 **surcharge calculation?**

6 A. No. OPC's adjustments are inconsistent with statutory authority, commission rule, and  
7 the tax normalization rules.

8

9 **Q. Can you explain further, why OPC's adjustments to MAWC's calculation is**  
10 **inconsistent with relevant statutory guidance, commission rule, and the tax**  
11 **normalization rules?**

12 A. Yes. With respect to statutory authority and Commission rules on ISRS, a plain reading  
13 of both indicate the calculation should include a provision for income taxes consistent  
14 with MAWC's Application. OPC's adjustment to exclude net accumulated deferred  
15 income taxes is inconsistent with these rules. Additionally, the WACC that OPC  
16 proposes is inconsistent with the Non-unanimous Stipulation in Case WR-2015-0301,  
17 approved by the Commission, which states for ISRS purposes, a 10.35% pre-tax cost  
18 of capital should be used.

19

20 **Q. Is OPC's proposed treatment of taxes in this proceeding a normalization**  
21 **violation?**

22 A. Yes it is. OPC's proposal is simply what would occur if a flow-through method of  
23 accounting was used. OPC's approach would flow income tax expense to customers  
24 in the cost of service component in computing the ISRS surcharge, and thus the OPC

1 reflects no net balance in ADIT or the zero cost of capital balance in the net original  
2 cost component of the ISRS surcharge calculation.

3

4

#### **V. NORMALIZATION**

5

6 **Q. Can you please describe Normalization as a method of accounting for income tax**  
7 **expense and benefit as simply as you can?**

8

A. Yes. Normalization in this context means that income tax expense as recovered in rates  
9 equals the income tax expense computed on regulatory pre-tax (“book”) cost of service.  
10 Tax expense is the sum of current tax expense and deferred tax expense. Current tax  
11 expense is based on what will be paid for the current tax year on the taxable (“tax”)  
12 income that will be reported on a tax return for the tax year, and deferred tax expense  
13 is based on the book to tax income timing differences. Deferred taxes accumulate to  
14 the balance sheet until reflected on a future tax return. The net deferred income tax  
15 liability is in effect, and as a general matter in ratemaking, treated as a source of cost-  
16 free capital in the context reducing the rate base on which a utilities return is computed,  
17 and customer rates are established. More succinctly, normalization spreads the tax  
18 benefits received from taking advantage of tax incentives such as accelerated  
19 depreciation and bonus depreciation over the book life of the underlying investments.

20

21 **Q. Are utilities always immediately able to take advantages of the full benefits of**  
22 **participating in tax incentives such as accelerated depreciation and bonus?**

23

A. No. This is especially true in years that bonus depreciation deductions are available  
24 and where utilities are making significant investments in plant.

25

1 **Q. Can you explain, what occurs on the tax return that delays the receipt of cash tax**  
2 **benefit to the utilities?**

3 A. Yes. The tax benefit of claiming accelerated or bonus depreciation is a reduction in  
4 taxable income and the tax liability that would otherwise accrue. Once taxable income  
5 and tax liability is reduced to zero, any additional deductions create a net operating loss  
6 that can be carried forward to apply to future taxable income and resulting future tax  
7 obligations. Note, a two-year carryback is also allowed, but the carryback requires  
8 taxable income to reduce in those years. MAWC did not have taxable income in the  
9 prior two years. Bonus depreciation allows for an immediate tax deduction equal to  
10 50% of the capital investment placed in service during the year. Once that same plant  
11 investment is included in rates, it generally only produces revenue and taxable income  
12 based on the authorized cost of capital, book depreciation and other related expenses,  
13 which will not generate enough taxable income to fully utilize the tax deduction.  
14 Therefore, absent significant other taxable income and tax obligations arising from  
15 prior period plant investments and base utility activities, which will often also include  
16 significant tax depreciation deductions in excess of taxable income, accelerated and  
17 bonus depreciation deductions on new plant investments will increase the utility's  
18 NOLC. As a general matter, MAWC and other utilities that utilized bonus depreciation  
19 for a number of successive years, and who continue to make significant plant  
20 investments are building their NOLCs by claiming accelerated tax depreciation and  
21 bonus on new plant additions.

22

1 **Q. Can you explain what occurs on a utility’s regulated balance sheet when the**  
2 **receipt of the tax benefit from claiming accelerated and bonus tax depreciation is**  
3 **delayed?**

4 A. Yes. The total amount of accelerated depreciation and bonus claimed in excess of book  
5 depreciation is multiplied by the effective tax rate and carried as an Accumulated  
6 Deferred Tax Liability Balance (“DTL”). The total of these deductions in excess of  
7 taxable income is an increase to the NOLC. This amount is multiplied by the effective  
8 tax rate and carried as an Accumulated Deferred Tax Asset Balance (“DTA”). The  
9 combined DTL and DTA is reported as a net accumulated deferred income tax liability  
10 on utility’s GAAP and regulated balance sheet. The DTL balance related to accelerated  
11 depreciation will reverse or be normalized over the book depreciation life of the  
12 underlying investments. The DTA will reverse or be normalized as the benefit of the  
13 NOLC is used to reduce taxable income and tax liabilities in future periods. The  
14 reversal of both the DTL and DTA will be reported as part of the change in the net  
15 accumulated deferred income tax liability on utilities GAAP and regulated balance  
16 sheet.

17  
18 **Q. Economically, what do the net liabilities represent and how are they treated in**  
19 **rate making?**

20 A. Economically, the ADIT net liability represents a source of cost free capital to the  
21 utility. As such, the net liability is considered in ratemaking under two alternative  
22 methods. The first method, which is generally most common, is to reduce rate base by  
23 including the ADIT as a line item in rate base. The alternative to this method is to  
24 include the ADIT balance in the capital structure. Under this method, the allowed rate

1 of return is lower because including zero cost capital in the weighted average cost of  
2 capital lowers than the overall allowed rate of return. Either method has the same  
3 economic effect, in that the allowed return is reduced. In the first case the rate base is  
4 lowered, in the second the weighted average cost of capital is lowered. The result is  
5 the same under either method.

6

7 **Q. Is Normalization the only method that exists to compute income tax expense in**  
8 **cost of service rate making?**

9 A. No. There is another method, commonly called “flow-through”. Under flow-through  
10 income tax expense only includes actual taxes payable based upon the tax return.  
11 Under this method, all net tax benefits from Book / Tax Differences flow through to  
12 ratepayers immediately, and as such, no zero cost capital is available to the utility.

13

14 **Q. Is either Normalization or Flow-Through considered a better method?.**

15 A. The answer to that would depend on whom you ask. The customers of a utility using  
16 accelerated tax depreciation, using flow-through accounting and ratemaking receive  
17 significant tax benefits at the time of initial investment. Supporters of flow-through  
18 like it because of the short-term reductions in cost of service that result. However,  
19 supporters of Normalization will point out that those taxes eventually will have to be  
20 repaid to the utility in the future. This future burdening of the children and  
21 grandchildren of those who received the benefit creates intergenerational equity issues.  
22 Many believe normalization is a better method because the tax benefit of the  
23 investments are enjoyed equally by all users of the asset over time. However, this  
24 question is somewhat moot point in the context of the issues need to be resolved in this

1 case, since the flow-through method of accounting is inconsistent with tax  
2 normalization rules.

3

4 **VI. FEDERAL INCOME TAX NORMALIZATION**

5 **Q. Please Describe the Federal Income Tax Normalization Rules**

6 A. In about 1969, Congress enacted the first Federal Income Tax Normalization rules. The  
7 first set of normalization rules allowed some utilities to continue flow-through  
8 accounting for a transitional period. By 1981, these rules had been updated, and all  
9 property placed in service by a utility after 1980 is subject to the normalization rules.  
10 The Federal normalization rules function as described above in the general discussion  
11 on normalization. The rules indicate that public utility property is qualified for  
12 accelerated depreciation only if a normalization method of accounting is used related  
13 to that property. If a utility or its Commission violates the normalization rules, the  
14 property ceases to be eligible for accelerated depreciation. As a result, there is no  
15 longer a tax benefit to using the flow-through method.

16

17 **Q. Why would Congress care about how a particular federal agency, or state utility  
18 commission sets its rates?**

19 A. The reason goes back to the overall policy issue that exists related to instituting  
20 accelerated depreciation in the first place. Accelerated depreciation exists because it  
21 provides businesses a cost free source of capital. If a commission requires flow  
22 through, the income taxes serve to simply lower rates in the short term and as such,  
23 they do not provide cost free capital. The utility has to replace the capital with higher  
24 cost debt and equity.

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**Q. What did Congress consider doing as a result?**

A. Since Congress felt that accelerated depreciation at a utility was not accomplishing its policy objective, the simplest thing to do would be to disallow accelerated depreciation for all public utility property.

**Q. What did Congress ultimately do?**

A. Congress enacted the normalization rules. It was considered a great compromise. In simple terms, accelerated depreciation is only available to a public utility if that utility receives the intended benefits of accelerated depreciation. That can only occur if a normalization method of accounting is used and allowed subject to regulation.

**Q. Why is this information related to Congress' intent so important? .**

A. This is extremely important because many people question the fact that Congress is imposing on a Commission's right to set rates. As a result, they might dismiss the rules. However, that is not the case. When granting a tax benefit, Congress views that it has made the equivalent of an expenditure. If Congress believes the expenditure will not ultimately result in the intended policy purpose it should not make the expenditure. Congress did not intend for utilities to flow-through the benefit and lower rates in the short term. Instead, Congress wanted utilities to have cost free capital consistent with the policy purposes of accelerated depreciation. Congress left Commissions free to require flow-through as a method to account for tax depreciation. However, Congress then intended that utilities subject to that Commission's authority not be entitled to the tax incentives inherent in accelerated depreciation and bonus.

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**Q. Please describe how the normalization rules function and what is included in their scope?**

A. The normalization rules generally function as discussed in the section above. However, in addition there are some specific areas I will mention below to enhance and supplement the above discussion:

- Scope – The normalization rules are limited in scope. They only apply to the difference between tax depreciation on tax basis in assets and the amount of depreciation that would exist if those same assets were depreciated using book lives and methods.
- Limitations on the amount of ADIT that can be included as a rate base reduction or as zero cost capital in the capital structure
  - Proration – Proration is not an issue in the instant proceeding, and as such I will not discuss it
  - Limitations on the amount of Rate Base Reduction where the taxpayer experiences an NOLC – This is described below in the next section
- Excess Deferred income taxes – There are rules on return of excess deferred taxes. Excess deferred taxes are not an issue in this case and will not be discussed.
- Consistency - The normalization rules generally require consistency between the treatment of tax expense, depreciation expense, or reserve for deferred taxes and rate base.



1 **VII. INCOME TAX NORMALIZATION – CONSIDERATIONS WHEN TAXPAYER**  
2 **HAS A NET OPERATING LOSS (“NOL”) CARRYFORWARD (“NOLC”)**

3  
4 **Q. What is an NOL?**

5 A. An NOL occurs when deductions in a given tax period are greater than income for that  
6 tax period.

7  
8 **Q. When an NOL occurs, what generally happens?**

9 A. When business incurs an NOL, no taxes are paid for that year, and any excess loss is  
10 carried forward to a future year to be applied to taxable income reducing resulting tax  
11 obligations in that year(s)

12  
13 **Q. Can you, in very simple terms, explain how an NOLC might affect the tax  
14 deduction received by a utility for accelerated depreciation?**

15 A. I will try to do so with a very simple set of examples. First, assume a utility has one  
16 depreciation related Book / Tax Difference of \$100. Further, assume pre-tax book  
17 income is \$200. Finally, assume a corporate income tax rate of 35%. In that case,  
18 normalized income tax expense is equal to \$70 (\$200 of pre-tax book income X 35%  
19 tax rate) Of that \$70 of income tax expense, \$35 dollars is payable currently (\$200 of  
20 pre-tax book income less \$100 of Book / Tax Difference = \$100 of taxable income  
21 times the corporate tax rate of 35% = \$35 of current taxes payable). The remaining  
22 \$35 of income tax expense is added to ADIT as a liability. In this case, it is clear that  
23 the utility received a benefit of \$35 in the form of a zero cost loan from the government.  
24 This amount can be included as a rate base reduction.

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Now let's layer in an NOLC. To do so we will assume the utility cannot carry back the NOL. Also, we will assume that the utility's property was qualified for bonus depreciation and as such, the Book / Tax difference is now \$300. All other factors are the same. The utility will have the same normalized tax expense of \$70. (\$200 of pre-tax Income times 35% tax rate) However, in this example, because the utility will incur an NOL of \$100. (\$200 pre-tax income less \$300 Book / Tax Difference = a \$100 NOL). As a result, no tax payment is made, and the \$70 normalized tax expense is added in to the ADIT balance. The difference here is that the ADIT is made up of two pieces. The first is the normal ADIT liability that is recorded because of temporary depreciation differences of \$105. (\$300 Book / Tax Difference times 35% tax rate = \$105 ADIT liability) However, because the utility is has a \$100 NOL, this results in negative tax benefits or in other words a deferred tax asset of \$35 (\$100 NOL times 35% tax rate).

**Q. I follow the numbers, but can you describe what it means in economic terms?**

A. As we can see from the above, the Book / Tax Difference for depreciation created an increase to ADIT liabilities of \$105. This normally represents cost free capital received from the government. However, because the deduction for depreciation was so large, the company did not receive the full amount of the cost free capital from the government. Instead, the company received a promise from the government to receive that capital at some time in the future via the 20 year carryforward rules. Essentially the utility made a loan to the government, in that as long as the company has taxable income in the next 20 years, the government will give the remainder of the cost free

1 capital to the company. The net ADIT is still the proper amount to deduct from rate  
2 base as it represents the net cost free capital actually received by the utility.

3

4 **Q. You stated above that the scope of the Normalization rules only incorporates**  
5 **Depreciation. Is the deferred tax asset related to the NOL in scope as well?**

6 A. Yes to the extent the NOL is caused by depreciation deductions.

7

8 **Q. Please provide the law or regulation requiring the NOL to be included as an**  
9 **increase to rate base.**

10 A. Now we will have to move away from simple examples and look to the actual  
11 regulation that addresses the NOLC. Treasury Regulation 1.167(l)-1 generally defines  
12 the computation of deferred income taxes, and addresses NOL Carryforwards.  
13 Specifically Treasury Regulation 1.167(l)-1(h)(1)(iii) states:

14 *“Except as provided in this subparagraph, the amount of Federal income tax*  
15 *liability deferred as a result of the use of different method of depreciation under*  
16 *subdivision (i) of this subparagraph is the excess (computed without regard to*  
17 *credits) of the amount the tax liability would have been had a subsection (l)*  
18 *method been used over the amount of the actual tax liability. Such amount shall*  
19 *be taken into account for the taxable year in which such different methods of*  
20 *depreciation are used. If, however, in respect of any taxable year the use of a*  
21 *method of depreciation other than a subsection (l) method for purposes of*  
22 *determining the taxpayer's reasonable allowance under section 167(a) **results***  
23 ***in a net operating loss carryover (as determined under section 172) to a year***  
24 ***succeeding such taxable year which would not have arisen (or an increase in***

1            *such carryover which would not have arisen) had the taxpayer determined*  
2            *his reasonable allowance under section 167(a) using a subsection (l) method,*  
3            *then the amount and time of the deferral of tax liability shall be taken into*  
4            *account in such appropriate time and manner as is satisfactory to the district*  
5            *director.”*

6  
7    **Q.    There are a lot of code section references, can you explain that in English? .**

8    A.    Yes. What the above is saying, if you strip away all the technical jargon, is:

- 9            • The amount of normalized tax to add to ADIT that can be used to reduce rate base  
10           is the difference in tax caused by accelerated depreciation. This has been discussed  
11           at length above.
- 12           • However, to the extent that the amount of accelerated depreciation causes an NOL  
13           for the year that will be carried forward, the carry forward affects the timing of the  
14           allowed rate base reduction. The regulation did not provide any further guidance  
15           on the timing.

16  
17   **Q.    Since the regulation did not provide guidance, did any other guidance get**  
18   **published by Treasury or the IRS?**

19   A.    In recent times there have been several Private Letter Rulings (“PLR”) that have been  
20   issued. All of these provide a basic framework for interpreting the regulation.

21  
22   **Q.    Without regard to the PLRs, do you have an opinion on what is the correct**  
23   **treatment of the net ADIT in cases where there is an NOLC?**

1 A. Yes. It is my opinion that the rate base reduction caused by the ADIT that arises from  
2 depreciation must be reduced by the economic reality that the company has not actually  
3 received the full amount of the cost free capital. I would like to make a very important  
4 point in this regard. In the simple example above, we analyzed the effects of  
5 accelerated depreciation and how it creates a rate base reduction. We further looked at  
6 what occurs when there is an NOLC. There is no other acceptable answer than to net  
7 the ADIT asset resulting from the NOLC against the ADIT liability from accelerated  
8 depreciation. Any other answer does not reflect the simple economic reality of the  
9 situation.

10

11 **Q. Do the PLRs support your opinion?**

12 A. Yes. There have been several PLRs issued since 2015 that address the issue. I will use  
13 PLR 201548017 as the source of all quotes, and it is provided as Schedule JRW-2.  
14 Additional PLRs are attached as Schedule JRW-3 through Schedule JRW-7.

15

16 **Q. Does the PLR discuss the regulation cited above and confirm your testimony  
17 above as to the guidance it provides?**

18 A. Yes, in the PLR the IRS representative acknowledges the lack of guidance and  
19 addresses it as follows:

20 *Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be*  
21 *taken into account for normalization purposes. Further, while that section*  
22 *provides no specific mandate on methods, it does provide that the Service has*  
23 *discretion to determine whether a particular method satisfies the normalization*  
24 *requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use*

1            *a normalization method of regulated accounting if, for ratemaking purposes,*  
2            *the amount of the reserve for deferred taxes which is excluded from the base to*  
3            *which the taxpayer's rate of return is applied, or which is treated as no-cost*  
4            *capital in those rate cases in which the rate of return is based upon the cost of*  
5            *capital, exceeds the amount of such reserve for deferred taxes for the period*  
6            *used in determining the taxpayer's expense in computing cost of service in such*  
7            *ratemaking. Because the ADIT account, the reserve account for deferred taxes,*  
8            *reduces rate base, it is clear that the portion of an NOLC that is attributable to*  
9            *accelerated depreciation must be taken into account in calculating the*  
10           *amount of the reserve for deferred taxes (ADIT).*

11  
12  
13    **Q.    The above makes it clear that at least the amount of the NOL Carryforward**  
14    **attributable to accelerated depreciation included as an increase to rate base to**  
15    **offset the decrease from accelerated depreciation. Does the PLR provide guidance**  
16    **as to determine how much of the NOL relates to accelerated depreciation?**

17    A.    In order to avoid a normalization violation, to determine how much of the ADIT asset  
18    related to depreciation the IRS states:

19  
20            *The "last dollars deducted" methodology employed by Taxpayer is specifically*  
21            *designed to ensure that the portion of the NOLC attributable to accelerated*  
22            *depreciation is correctly taken into account by maximizing the amount of the*  
23            *NOLC attributable to accelerated depreciation. This methodology provides*  
24            *certainty and prevents the possibility of "flow through" of the benefits of*

1            *accelerated depreciation to ratepayers. Under these facts, any method other*  
2            *than the “last dollars deducted” method would not provide the same level of*  
3            *certainty and therefore the use of any other methodology is inconsistent with*  
4            *the normalization rules*

5  
6    **Q.    How does the IRS state the above in the “Holdings” section of the ruling?**

7    A.    The IRS states:

8            *Under the circumstances described above, the reduction of Taxpayer’s rate*  
9            *base by the balance of its ADIT accounts unreduced by its NOLC-related*  
10           *deferred tax account would be inconsistent with the requirements of § 168(i)(9)*  
11           *and § 1.167(l)- 1 of the Income Tax regulations. 2. Under the circumstances*  
12           *described above, the reduction of Taxpayer’s rate base by the full amount of its*  
13           *ADIT account balances offset by a portion of its NOLC related account balance*  
14           *that is less than the amount attributable to accelerated depreciation computed*  
15           *on a “last dollars deducted” basis would be inconsistent with the requirements*  
16           *of § 168(i)(9) and § 1.167(l)-1. 3. Under the circumstances described above,*  
17           *any reduction in Taxpayer’s tax expense element of cost of service to reflect the*  
18           *tax benefit of its NOLC would be inconsistent with the requirements of §*  
19           *168(i)(9) and § 1.167(l)-1.*

20  
21   **Q.    Please explain the above in a summary statement**

22   A.    Including a reduction to rate base for ADIT liabilities related to accelerated  
23        depreciation without reducing that amount by the ADIT asset related to the NOL caused  
24        by the accelerated depreciation would cause a normalization violation. Further to

1 determine the amount of the ADIT asset to include as a reduction to the ADIT liability  
2 would have to be done on a “last dollar deducted method or in other rulings a with and  
3 without method. Any other method would cause a normalization violation. Finally  
4 any reduction to tax expense below the normalized tax expense would cause a  
5 normalization violation.

6

7 **Q. The IRS rulings provide a method of determining how much of the NOLC DTA**  
8 **should be included as an offset to the DTL for depreciation. Should MAWC**  
9 **include only that portion of the NOL DTA?**

10 A. MAWC should include the entire amount of the NOL DTA. It is my opinion that  
11 without regard to the above regulations or PLRs, the entire NOL ADIT asset that is  
12 caused by any cost included in a given regulatory proceeding should be included as an  
13 addition to rate base.

14

15 **Q. Does this conclude your direct testimony?**

16 A. Yes it does.



**Missouri American Water**  
**WO-2018-0059**  
**Schedule JRW-1**

For investments made from February 2016 through June 2017, depreciated through November 2017

Book	MAWC	Staff	OPC
ISRS Revenues	0	0	0
<b>Total Revenues</b>	<b>0</b>	<b>0</b>	<b>0</b>
Property Taxes	0	0	0
Depreciation Expense	602,210	602,210	602,210
Interest Expense	1,243,815	1,243,815	0
<b>Total Expenses</b>	<b>1,846,025</b>	<b>1,846,025</b>	<b>602,210</b>
<b>Pre-Tax Income (Loss)</b>	<b>(1,846,025)</b>	<b>(1,846,025)</b>	<b>(602,210)</b>
Effective Tax Rate	38.3886%	38.3886%	0.0000%
<b>Tax Expense</b>	<b>(708,664)</b>	<b>(708,664)</b>	<b>0</b>
Tax	MAWC	Staff	OPC
ISRS Revenues	0	0	0
<b>Total Revenues</b>	<b>0</b>	<b>0</b>	<b>0</b>
Property Taxes	0	0	0
Depreciation Expense	24,374,352	24,374,352	0
Interest Expense	1,243,815	1,243,815	0
<b>Total Expenses</b>	<b>25,618,167</b>	<b>25,618,167</b>	<b>0</b>
<b>Pre-Tax Income (Loss)</b>	<b>(25,618,167)</b>	<b>(25,618,167)</b>	<b>0</b>
Deferred Tax Liability	MAWC	Staff	OPC
Book Depreciation	602,210	602,210	0
Tax Depreciation	24,374,352	24,374,352	0
Book / Tax Difference	(23,772,142)	(23,772,142)	0
Effective Tax Rate	38.3886%	38.3886%	0.0000%
<b>Deferred Tax Liability</b>	<b>(9,125,800)</b>	<b>(9,125,800)</b>	<b>0</b>
Deferred Tax Asset	MAWC	Staff	OPC
Net Operating Loss	25,618,167	25,618,167	0
Effective Tax Rate	38.3886%	38.3886%	0.0000%
<b>Deferred Tax Asset</b>	<b>9,834,463</b>	<b>9,834,463</b>	<b>0</b>
<b>Net Accumulated Deferred Income Tax</b>	<b>708,664</b>	<b>708,664</b>	<b>0</b>
Rate Base Adjustment	MAWC	Staff	OPC
Deferred Tax Liability - Depreciation	(9,125,800)	(9,125,800)	0
Deferred Tax Asset - NOL	9,834,463	0	0
<b>Net Rate Base Adjustment</b>	<b>708,664</b>	<b>(9,125,800)</b>	<b>0</b>
Rate Base	MAWC	Staff	OPC
Net Utility Plant in Service	46,608,382	46,608,382	46,549,556
Net Accumulated Deferred Taxes	708,664	(9,125,800)	0
<b>Rate Base</b>	<b>47,317,046</b>	<b>37,482,583</b>	<b>46,549,556</b>
ISRS Revenues	MAWC	Staff	OPC
Cost of Capital	10.35%	10.35%	7.39%
Return on Rate Base	4,897,314	3,879,447	3,439,268
Expenses	741,443	741,443	741,442
<b>Revenue Requirement on ISRS</b>	<b>5,638,757</b>	<b>4,620,890</b>	<b>4,180,710</b>
Prior ISRS Reconciliation	2,484,500	2,484,500	0
<b>Total ISRS Revenues</b>	<b>8,123,257</b>	<b>7,105,390</b>	<b>4,180,710</b>

**Notes:** 1) Original Company filing was \$8,127,145, Company identified corrections of \$3,888 which were included in an update sent to Staff and OPC.

2) Staff did not indicate any differences with Company's calculation of income tax expense, or net ADIT, but excluded the NOL Deferred Tax Asset from the Rate Base calculation

**IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201548017 (Aug. 19, 2015), Internal Revenue Service, (Aug. 19, 2015)**

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LTR 201548017, August 19, 2015

Symbol: CC:PSI:B06-PLR-116998-15

**Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

**Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated May 14, 2015, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is primarily engaged in the regulated distribution of natural gas in State A. It is incorporated in State B and is wholly owned by Parent. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer incurred net operating losses (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between net regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of a net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission offsets rate base by Taxpayer's ADIT balance. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission was, if Commission allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then an offsetting reduction should be made to Taxpayer's income tax expense element of service.

A Utility Law Judge upheld Taxpayer's position with respect to the NOLC-related ADIT and ordered Taxpayer to seek a ruling from the Internal Revenue Service on this matter. This request is in response to that order.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's

reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the proposed order by the Utility Law Judge upholding Taxpayer's position that

the NOLC-related deferred tax account must be included in the calculation of Taxpayer's ADIT is in accord with the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. In addition, such adjustment would be made specifically to mitigate the effect of the normalization rules in the calculation of Taxpayer's NOLC-related ADIT. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). This "offsetting reduction" would violate the normalization provisions.

Based on the representations submitted by Taxpayer, we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of Associate Chief Counsel (Passthroughs & Special Industries).

cc: \*\*\*\*\*

**IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201436038 (May. 22, 2014), Internal Revenue Service, (May 22, 2014)**

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LTR 201436038, May 22, 2014

Symbol: CC:PSI:B06-PLR-148311-13

**Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

**Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned, through a limited liability company, by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer also provides natural gas and natural gas transmission services in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries — a "deferred tax asset" and a "deferred tax expense" — that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case was updated in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT.

On Date C, a settlement agreement was filed with Commission B, incorporating the Taxpayer's proposed treatment of the tax consequences of its NOLC. In an order issued on Date D, Commission B issued an order

approving the settlement agreement and also ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date E.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional eight months. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.



In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: \*\*\*\*\*

## **IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201438003 (Jun. 12, 2014), Internal Revenue Service, (Jun. 12, 2014)**

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LTR 201438003, June 12, 2014

Symbol: CC:PSI:B06-PLR-104157-14

### **Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

#### **Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated January 24, 2014, and additional submission dated May 19, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying electricity in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A and Commission B with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year C. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year D.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries — a "deferred tax asset" and a "deferred tax expense" — that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that

Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of “cost-free” capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission A, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission A further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission A also held that to the extent tax normalization rules require recording the NOL to rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a “with and without” basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of

accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and

ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission A is not in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: \*\*\*\*\*

## **IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201519021 (Feb. 04, 2015), Internal Revenue Service, (Feb. 4, 2015)**

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LTR 201519021, February 04, 2015

Symbol: CC:PSI:B06-PLR-136851-14

### **Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

#### **Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated October 1, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying natural gas service in State A. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of service. Taxpayer's rates are established on a cost of service basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year D. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in each of Year B, Year C, and Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year C and Year D, the beginning and end of the test period.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission also held that to the extent tax normalization rules require including the NOL in rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.



Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission is not in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

**IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201534001 (May. 13, 2015), Internal Revenue Service, (May 13, 2015)**

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LTR 201534001, May 13, 2015

Symbol: CC:PSI:B06-PLR-103300-15

**Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

**Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated January 9, 2015, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is the common parent of an affiliated group of corporations and is incorporated under the laws of State A and State B. Taxpayer is engaged primarily in the businesses of regulated natural gas distribution, regulated natural gas transmission, and regulated natural gas storage. Taxpayer's regulated natural gas distribution business delivers gas to customers in several states, including State A. Taxpayer is subject to, as relevant for this ruling, the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of its gas distribution service in State A. Taxpayer's rates are established on a "rate of return" basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer's application was based on a fully forecasted test period consisting of the twelve months ending on Date B. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. In a final order dated Date C, rates were approved by Commission for service rendered on or after Date D.

In each year from Year A to Year B, Taxpayer incurred a net operating loss carryforward (NOLC). In each of these years, Taxpayer claimed accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State C, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. The attorney general for State C argued against Taxpayer's proposed calculation of ADIT.

Commission, in its final order, agreed with Taxpayer but concluded that the ambiguity in the relevant normalization regulations warranted an assessment of the issue by the IRS and this ruling request followed.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable

year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, to reduce Taxpayer's rate base by the full amount of

its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The “last dollars deducted” methodology employed by Taxpayer ensures that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of “flow through” of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the “last dollars deducted” method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

cc: \*\*\*\*\*

## **IRS Letter Rulings and TAMS (Current), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201709008 (Dec. 02, 2016), Internal Revenue Service, (Dec. 2, 2016)**

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LTR 201709008, December 02, 2016

Symbol: CC:PSI:B06-PLR-119381-16

### **Uniform Issue List No. 0167.22-01**

[\[Code Sec. 167\]](#)

#### **Depreciation; Public utility property; Normalization rules.**

This letter responds to the request, dated June 15, 2016, submitted by Parent on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is an integrated electric utility headquartered in State. Taxpayer is a wholly owned subsidiary of Parent and is included in Parent's consolidated federal income tax return. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer's business includes retail electric utility operations regulated within State by Commission A and Taxpayer is subject to the regulatory jurisdiction of Commission B with respect to terms and conditions of its wholesale electric transmission service and as to the rates it may charge for the provision of such services. Taxpayer's rates are established on a cost of service basis.

On Date 1, Taxpayer filed a rate case application (Case) with Commission B requesting authorization to change from charging stated rates for wholesale electric transmission service to a formula rate mechanism pursuant to which rates for wholesale transmission service are calculated annually in accordance with an approved formula. The proposed formula consisted of updating cost of service components, including investment in plant and operating expenses, based on information contained in Taxpayer's annual financial report filed with Commission B, as well as including projected transmission capital projects to be placed into service in the following year. The projections included are subject to true-up in the following year's formula rate.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. Taxpayer incurred a net operating loss (NOL) in each of Year 1 through Year 2 due to Taxpayer's claiming bonus depreciation, producing a net operating loss carryover (NOLC).

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" – that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of a NOLC.



In the setting of utility rates by Commission B, a utility's rate base is offset by its ADIT balance. In its rate case filing, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules.

On Date 2, Commission B issued an order accepting Taxpayer's revisions to its rates. On Date 3, new rates went into effect, subject to refund. Several intervenors submitted challenges to the rate case and on Date 4, Taxpayer and those intervenors entered into a Settlement Agreement, which was filed with Commission B. On Date 5, Commission B issued an order accepting the Settlement Agreement, which allows for the inclusion of the ADIT related to the NOLC asset in rate base.

Commission B further stated in the order that it is the intent of Commission B that Taxpayer comply with the normalization method of accounting and tax normalization regulations. The order also requires Taxpayer to seek a private letter ruling (PLR) from the Service regarding Taxpayer's treatment of the ADIT related to the NOLC asset. Commission B also noted that after the Service issues a PLR, Taxpayer shall adjust, to the extent necessary, its ratemaking treatment of the ADIT related to the NOLC asset prospectively from the date of the PLR.

Taxpayer requests that we rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.
2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

#### **LAW AND ANALYSIS**

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

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

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

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and

ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the order by Commission to include in rate base the ADIT asset resulting from the NOLC, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation is in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with or without" method would not provide the same level of certainty and therefore the use of any other methodology in computing the portion of the ADIT asset attributable to accelerated depreciation is inconsistent with the normalization rules.

We rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.
2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Patrick S. Kirwan, Chief, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).