EXH. MRM-3
DOCKETS UE-19___/UG-19___
2019 PSE GENERAL RATE CASE
WITNESS: MATTHEW R. MARCELIA

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**Docket UE-19____** **Docket UG-19____**

SECOND EXHIBIT (NONCONFIDENTIAL) TO THE
PREFILED DIRECT TESTIMONY OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

JUNE 20, 2019

Private Letter Ruling 8920025, 02/15/1989, IRC Sec(s). 167

UIL No. 0167.23-00; 0168.00-00

Full Text:

February 15, 1989

We received your private letter ruling request dated May 10, 1988, and all subsequently forwarded data. You have asked us to determine whether the proposed rate-making treatment of certain deferred income taxes meets the normalization requirements of sections 167 and 168 of the Internal Revenue Code. Specifically, you have asked us to rule as follows:

Whether Commission's proposed treatment of customer premises equipment (CPE) related excess deferred tax reserves for ratemaking purposes complies with the normalization requirements of sections 167(1) and 168(i)(9) of the Code, or whether the entire deferred tax balance should follow the property which was removed from regulation.

You have made the following representations:

Company is incorporated under the laws of State X and has its principal place of business in State Y. Company is a member of a group of affiliated corporations which files a consolidated federal income tax return on a calendar year basis. Parent of the group provides telephone and other forms of communications services, and manufactures telephone, communications, lighting and other electronic equipment and products. Company provides telephone and other communications services, and is subject to the jurisdiction of the Federal Communications Commission, and other commissions.

Company computes depreciation expense for federal income tax purposes utilizing an accelerated method of depreciation as permitted by section 167 or section 168 of the Code and utilizes a straight line method of depreciation for financial reporting and ratemaking purposes. Therefore, as required by section 167(1)(a)(G)(ii) and section 168(i)(9)(A)(ii), Company makes adjustments to a reserve for deferred income taxes to reflect the deferral of taxes resulting from the use of different depreciation methods. These adjustments to the deferred tax reserve have been computed based upon the prevailing tax rate at the time of deferral and the weighted average rate at the time of reversal.

Intrastate telephone service rates in State Y are regulated by Commission. These rates are based upon the sum of a cost of service component and a return on rate base component. The cost of service component essentially represents the ongoing cost of providing service (the costs of operating and maintaining the system) including depreciation and tax expense. Rate base is the original cost of Company's property used and useful in providing telephone service. This property is composed of telephone plant in service, cash working capital, and materials and supplies inventory, less accumulated depreciation and deferred tax reserves.

Commission allows Company to earn a return on this rate base. Cost of service and rate base used for establishing telephone rates in State Y are based upon historical test period data, adjusted for known and measurable changes which affect the test period data.

Company records deferred tax reserves based on the difference between accelerated depreciation for tax purposes and a straight-line depreciation computation applied to the tax basis of plant. Originating differences are recorded in the early years of an asset's life, when accelerated depreciation exceeds straight-line depreciation, based on the corporate income tax rate in effect during the originating period. Reversals or terminating differences are recorded in the late years when straight-line depreciation exceeds accelerated depreciation. The amount of the reversal is computed based on a weighted average of the tax rates in effect when the corresponding originating differences relating to each vintage account were recorded. Any reductions or increases in corporate income tax rates do not directly result in an immediate reduction or increase in Company's previously recorded deferred tax reserves.

On October 22, 1986, with the enactment of the Tax Reform Act of 1986 (the "Act"), corporate income tax rates were reduced from 46 percent to 34 percent effective for tax years beginning on or after July 1, 1987. This reduction in corporate income tax rates by the Act resulted in an "excess" amount in the deferred tax reserves that were established as a result of normalizing the income tax effect of the difference between regulatory and tax depreciation of public utility property. Generally, the excess deferred tax reserves are defined as the reserves for deferred taxes computed under prior law, less what the reserves for deferred tax would be if the tax rate in effect under the Act had been in effect for all the prior periods.

Technological advances and increases in competition have rendered the regulation of certain services provided by Company as inappropriate. Among the services permitted to be deregulated was the leasing of embedded CPE to its subscribers by telephone companies. CPE consists of such items as telephone instruments, radio paging/mobile equipment, data sets, dialers and other supplemental equipment.

On a, Commission ordered Company, in Docket Z, regarding the transfer of embedded CPE to deregulated operations, to transfer its embedded CPE investment and the associated depreciation reserves, deferred tax reserves and unamortized investment tax credits from its regulated to its nonregulated books of account. The excess deferred tax reserves resulting from the reduction in corporate income tax rates were not, however, ordered transferred to Company's nonregulated books of account.

Commission proposed that these excess deferred tax reserves be amortized as a reduction in regulated expenses over the appropriate period as required by section 203(e) of the Act. Conversely, Company proposed that when the embedded CPE is removed from the regulated books of account, the entire deferred tax reserves attributable to such property should be transferred along with it.

Section 168(f)(2) of the Code provides that accelerated cost recovery depreciation shall not apply to " {A}ny public utility property . . . if the taxpayer does not use a normalization method of accounting."

Section 168(i)(9)(A) of the Code requires that, in order to use a normalization method of accounting, adjustments must be made to a reserve to reflect the deferral of taxes resulting from the use of different depreciation methods for tax purposes and for establishing its cost of service.

Section 168(i)(9)(B) of the Code provides that the normalization requirements are not met if the taxpayer uses a procedure or adjustment which is inconsistent with the section 168(i)(9)(A) limitations. The procedures and adjustments which are inconsistent with these limitations "include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes . . . unless such estimate or projection is also used for ratemaking purposes with respect to the other 2 such items and with respect to the rate base."

Section 167(1) of the Code generally provides that public utilities are entitled to use accelerated methods of depreciation only if they use a normalization method of accounting. A "normalization method of accounting" is defined in 167(1)(3)(G) in a manner consistent with that found in the previously discussed section 168(i)(9)(A). The consistency requirements of Section 168 described above also apply to section 167(1).

Sections 167(1)(3)(G) and 168(i)(9) of the Code contemplate the creation of a reserve for deferred income taxes when depreciation for tax purposes is greater than depreciation for book purposes, and a reduction of the reserve when depreciation for tax purposes is less than depreciation for book purposes. Section 1.167(1)-1(h)(2)(i) of the regulations requires that the deferred tax reserve 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, and that the aggregate amount allocable to deferred tax under section 167(1) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

Section 203(e) of the Act sets forth a transitional rule for normalization excess deferred tax reserves resulting from the reduction of corporate income tax rates with respect to depreciation on assets placed in service before 1986. Under this rule, a taxpayer is not considered to be using a normalization method of accounting with respect to any of its assets if the excess deferred tax reserve is reduced more quickly or to a greater extent than the reserve would be reduced under the average rate assumption method.

Section 203(e)(1) of the Act provides that:

In General -- A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method."

The average rate assumption method was defined in section 203(e)(2)(B) of the Act as "the method under which the excess in the reserve for deferred taxes is reduced over the

remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes."

In this case, most of Company's deferred tax reserve was established during a period when the federal tax rate was at 46 percent. The federal income tax rate has now been reduced to 34 percent; therefore, the amount of the reserve with respect to the assets in question is larger than required at the current prevailing tax rate.

Commission concluded that their proposed treatment of CPE related excess deferred tax reserves will not reduce the reserve for deferred taxes below the amount that is necessary to accommodate the adjustments required by an acceptable normalization method of accounting during the period when the tax depreciation on the assets in question is less than the straight-line depreciation calculation by which deferred taxes are measured. Commission concluded furthermore that since the cost of service used in setting regulated rates reflected use of the normalization method of accounting for income taxes, the income tax expense component of cost of service included higher taxes than were actually incurred by Company.

The primary basis for including the higher income tax expense was, among other reasons, to allow Company the cost-free source of capital advantages associated with accelerated tax depreciation. Commission contends that the implicit assumption in using the higher tax expense in determining cost of service was that the tax savings accumulated in the deferred tax reserve account would be reversed later, when book depreciation exceeded tax depreciation. For these years this would result in a lower income tax expense for cost of service purposes than the income tax expense actually incurred. If the excess deferred tax reserves are transferred to the nonregulated accounts, rather than remaining in the regulated accounts, ratepayers will never receive the benefit of the reversal of these tax deferrals which no longer constitute a tax liability for Company. In contrast, shareholders will obtain from regulated operations higher deferred taxes reserves than required to pay CPE related federal tax liability. Commission, along with Commission's Staff and the State Y Attorney General, believe that the proposed treatment would meet the normalization requirements of the Code.

In addition, Commission Staff and State Y Attorney General did not find section 168(i)(9)(B) of the Code applicable to the situation in question. Section 168(i)(9)(B) deals with inconsistent estimates and projections of income tax expense, depreciation and the reserve for deferred taxes for ratemaking purposes. Section 203(e) of the Act clearly distinguishes "excess deferred tax reserves" from the reserve for deferred taxes and sets forth special regulatory treatment for the "excess deferred tax reserves". They believed that since the "excess deferred tax reserves" were not addressed in section 168(i)(9)(B), any references to this section were irrelevant to the instant case.

On the contrary, we believe that where property is removed from regulation, all taxes previously deferred in compliance with sections 167(1) and 168(i)(9) of the Code attributable to such property must also be removed from regulation. We also believe that section 203(e) of the Act does not override the consistency requirements of sections 167(1) and 168(i)(9). Indeed, Sec. 2.04 of Revenue Procedure 88-12 (1988-8 I.R.B. 15) provides that "section 203(e) of the Act does not modify the normalization requirements of section 167(1) or section 168(i) of the Code".

A violation of the normalization requirements of the Code will occur if the excess deferred taxes remain in regulation either as an immediate flow through to ratepayers or as a deferred tax which reduces rate base and cost of service, when the property which gave rise to the excess is no longer subject to regulation. This interpretation is supported by the consistency requirements of section 168(i)(9)(B) of the Code.

Section 203(e) of the Act does not redefine a normalization method of accounting. It does, however, provide that amounts which were originally deferred pursuant to a normalization method of accounting remain subject to the normalization rules of sections 167(1) and 168(i)(9) of the Code.[1] Accordingly, all amounts previously deferred under corporate tax rates at 46 percent are part of a "reserve to reflect the deferral of taxes" as described in sections 167(1)(2)(G)(ii) and 168(i)(9)(A)(ii), and become inseparable from the assets which initially gave rise to the deferral.

When property is removed from regulation in a nontaxable transfer, taxes previously normalized pursuant to sections 167(1) and 168(i)(9) of the Code must also be removed from regulation in order to carry out the intent of normalization. This is supported by the consistency requirements of section 168(i)(9)(B) and the regulations under section 167(1). A transfer of property from regulation, as ordered by Commission, without a transfer of all taxes deferred under statutory normalization, would result in an inconsistency; being that regulated cost of service and/or rate base would be reduced by a portion of the associated tax deferral while the asset is no longer subject to regulation, thereby not generating regulated depreciation expense.

The same conclusion can also be drawn if property is subject to more than one regulatory jurisdiction. As percentages of use shift between regulatory jurisdictions (or shift in or out of regulation), amounts subject to normalization follow those percentages proportionately. Section 1.167(1)-3(a)(2) of the regulations, and the example contained therein, makes the same connection between normalization of taxes and the underlying asset giving rise to the deferral. The aforementioned example clearly points out that in instances of multiple regulation of an asset (including a portion of an asset not subject to regulation), the percentage of an asset subject to a particular regulatory jurisdiction determines the extent to which a normalization violation is applicable.

Therefore, based on your representations and our legal analysis, we rule that:

Commission's proposed treatment of CPE related excess deferred tax reserves for ratemaking purposes does not comply with the normalization requirements of sections 167(1) and 168(i)(9) of the Code; the entire deferred tax balance should follow the property which was removed from regulation.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be use or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusions in the ruling. See section 16.04 of Rev. Proc. 89-1, 1989-1 I.R.B. 8, 19. However, when the criteria in section 16.05 of Rev. Proc. 89-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling are consummated.

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[1] Revenue Procedure 88-12 provides relief for those taxpayers who cannot comply with the average rate assumption method due to the absence of vintage records. Company maintains a deferred tax reserve through the use of vintage records, and, therefore, is required to use the average rate assumption method.