BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-20_____

DOCKET NO. UG-20_____

EXH. RLK-3

RYAN L. KRASSELT

REPRESENTING AVISTA CORPORATION

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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PLR-122510-19

Date:
March 26, 2020

In Re:

LEGEND:

Taxpayer	=
Parent	=
State A	=
Commission A	=
Commission B	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Month 1	=
Month 2	=
Year 1	=

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Dear :

This letter responds to a request for a private letter ruling dated September 26, 2019, and submitted on behalf of Taxpayer regarding the application of the depreciation normalization rules under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (together, the "Normalization Rules") to certain State A state regulatory procedures which are described in this letter. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer is an investor-owned regulated utility incorporated under the laws of State A. Taxpayer is an accrual basis taxpayer and reports on a calendar year basis.

Taxpayer is wholly owned by Parent. Parent is a State A corporation. Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent.

Taxpayer is a regulated utility engaged principally in the purchase, transmission, distribution, and sale of electric energy and the purchase, distribution, and sale of natural gas in State A. Taxpayer is subject to regulation as to rates and conditions of service by Commission A as well as Commission B. Both these regulators establish Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated businesses.

Taxpayer has claimed accelerated depreciation on all of its public utility property (both electric and gas) to the full extent those deductions have been available. Taxpayer has normalized the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of accumulated deferred federal income taxes (ADFIT) that is attributable to accelerated depreciation reflected on its regulated books of account for each of its divisions. In accordance with State A ratemaking practice, Taxpayer has reduced its rate base by its ADFIT balance.

Commission B has established a system to track accounts for both jurisdictional electric and gas companies. These accounts prescribe the accounting rules which are used by most large investor-owned electric and gas companies and are employed by Taxpayer's electric and gas divisions. The applicable regulations contain several definitions relevant to Taxpayer's inquiry including definitions for cost of removal (COR), salvage value, net salvage value, service value, and depreciation.

In general, based on these definitions, for purposes of regulatory reporting, the net positive value or net cost of disposing of an asset at the end of its life is incorporated into the annual depreciation charge. COR is, therefore, most often (but not always) a component of establishing the applicable depreciation rate. In Taxpayer's case, due to the amount of COR it anticipates, in almost all instances its assets have negative net salvage values so that its book depreciation rate is higher than it would be were salvage value not considered. In effect, the annual depreciation charge creates a reserve for COR over the operating life of the asset. Since book depreciation expense is included in Taxpayer's cost of service used for establishing its rates, customers pay for the COR as book depreciation is factored into their rates. This COR reserve is reflected as an addition to Taxpayer's accumulated depreciation account. When the COR is actually incurred, the amount expended is debited to that same account, thereby reducing the balance.

For tax purposes, COR is deductible only when actually incurred. Taxpayer, therefore, reports its customer collections that fund the COR reserve as taxable income over the operating life of an asset, claiming an offsetting tax deduction only at the end of the life of that asset. Taxpayer has normalized COR since the Year 1 tax year. All references below to COR-related deferred tax accounting relate only to COR associated with assets placed in service after Year 2. Since COR is normalized in setting rates, customers are provided a tax benefit commensurate with their funding of COR. In other words, they are provided the COR tax benefit as they fund the COR reserve – prior to the time Taxpayer actually claims that benefit on its tax return.

The tax effect of the COR funding as described creates a deferred tax asset ("DTA"). This represents the future benefit to be derived from the eventual COR tax deduction. The COR-related DTA is included in Taxpayer's overall plant-related ADFIT account that reduces Taxpayer's ADFIT balance.

COR can (and does) impact ADFIT balances in an additional way. The COR included in depreciation expense (that is, the accrual) is an estimate prepared for an entire class of assets contained in a Commission B account. It is likely that any COR estimate will be too high or too low with respect to any individual asset with the ultimate answer remaining unknown until all vintages of each asset class are retired and removed. Any running variance from the estimate is recorded on Taxpayer's balance sheet. Where the accrual exceeds the actual COR, it creates a net credit to the accumulated depreciation account. Where the actual COR exceeds the accrual, it creates a net debit to that account. This treatment means that Taxpayer will recover under-accruals from customers and refund over-accruals to customers through future rate adjustments. These future rate adjustments will give rise to future increases or decreases in taxable income. Under applicable accounting principles, Taxpayer must record the deferred tax consequences of these future events. An over-accrual produces a DTA (the tax benefit of a future deduction due to the refund of the excess collection) while an under-accrual produces a deferred tax liability “DTL” (the tax cost of future taxable income due to the collection of the shortfall).

For the electric distribution division, the COR book/regulatory accrual has always been included in the development of the book depreciation rate. Thus, instead of waiting for the Taxpayer to incur the tax benefit of COR, its’ Customers are provided the COR tax benefit as they fund the COR reserve – prior to the time Taxpayer actually claims that benefit on its tax return. This produces a DTA as described. In addition, as of Date 1, Taxpayer has, in total, incurred more COR than it has recovered from customers and, thus, is under-accrued for COR. This has produced a DTL, also as described. Both the DTA and DTL are included within Taxpayer’s overall plant-related ADFIT Account.

Prior to Month 1 Year 3, the gas distribution division accrued and collected COR as a component of the book depreciation rate. However, pursuant to order of Commission A, that collection practice was modified in Year 3. Beginning in Month 1 Year 3, the gas-only COR regulatory accrual was removed from the book depreciation rate. Rather, Taxpayer was allowed to record and recover annually (through a fixed dollar depreciation charge incremental to the normal depreciation computed via application of the depreciation rate) an amount representing an estimate of the annual COR that would be incurred in that year. At the time of this modification, the cumulative COR accrued exceeded COR actually incurred (that is, Taxpayer was over-accrued). At that time, Taxpayer had recorded a net DTA (to reflect the tax benefit of the future reduction in rates associated with refunding the excess to customers).

Since converting to this methodology in Year 3, COR actually incurred has significantly exceeded COR accrued and recovered, resulting in a DTL (the tax cost of recovering the under-accrual in the future). As of Date 1, the two components (pre-Month 1 Year 3 and post-Month 2 Year 3) combined represented a net DTL.

Effective Date 2, pursuant to an Order issued by Commission A, gas COR regulatory recovery has reverted back to a component of the book depreciation rate. The fixed dollar accrual which began in Year 3 has been eliminated.

Since Year 4, Taxpayer’s tax fixed asset system has separately identified the portion of Taxpayer’s book depreciation expense that relates to COR since that date. As a consequence, the system distinguishes between COR book/tax differences and depreciation method/life differences even though they are both derived from Taxpayer’s book depreciation. Though the system has the capability of tracking the reversals of these differences separately, in order to set it up to do this, a significant amount of work and data manipulation would be required. It is not currently configured in a manner that would allow this.

In years prior to Year 5, Taxpayer paid income tax at a 35% rate on the recovery of the COR portion of book depreciation (and provided its customers a tax benefit at that tax rate). However, as a result of the tax rate reduction enacted as part of the Tax Cuts and Jobs Act ("TCJA"), Taxpayer will only receive a 21% benefit when the COR deduction is claimed or when any over-accrual is refunded and will pay only a 21% tax on the recovery of any COR under-accrual. In other words, in the case of COR, the tax rate reduction enacted as part of the TCJA has produced both a deferred tax shortfall as well as an excess tax reserve. Because Taxpayer will not recover the 14% "excess" tax it paid on its recovery of the COR component of book depreciation from the government when it claims its COR deduction, it must recover it from its customers. Conversely, because Taxpayer will not pay the 14% "excess" deferred tax it accrued on its obligation to refund over-accrued COR, it must restore the amount to its customers (that is, it also has COR-related excess deferred taxes).

Taxpayer's Changes in Accounting Method for Mixed Service Costs and Repairs

Prior to Taxpayer's Year 6 tax year, in capitalizing its indirect overhead costs – including its mixed service costs – Taxpayer followed the same methodology for both book and tax purposes. Effective for its Year 6 tax year, Taxpayer filed with the Internal Revenue Service an Application for Change in Accounting Method (Form 3115) in which it requested permission to depart from its book method for tax purposes. The result of the change was to recharacterize a substantial quantity of mixed service costs that Taxpayer had previously capitalized into depreciable assets as deductible costs (including additions to cost of goods sold). This resulted in Taxpayer claiming a negative adjustment under § 481(a) (that is, a deduction) to remove from the tax basis of its existing assets all such recharacterized costs to the extent Taxpayer had not previously depreciated them ("Section 481 Adjustment").

Also, prior to Taxpayer's Year 6 tax year, in identifying deductible repairs, Taxpayer followed the same methodology for both book and tax purposes. Effective for its Year 6 tax year, Taxpayer filed an Application for Change in Accounting Method (Form 3115) in which it requested permission to depart from its book method for tax purposes. In general, under its new tax method, Taxpayer elected to use larger units of property than used for book purposes. The result of the change was to characterize many projects that were capitalized for book purposes as deductible repairs for tax purposes. This resulted in Taxpayer claiming a negative § 481 Adjustment to remove from the tax basis of its existing assets all such recharacterized costs to the extent Taxpayer had not previously depreciated them.

Adjustments (additions) were made to Taxpayer's ADFIT accounts, which already reflected the deferred tax consequences of having claimed accelerated depreciation on both types of costs after they were capitalized for tax purposes for the additional deferred taxes produced by the § 481 Adjustments.

Taxpayer's Recent Commission A Proceedings

On Date 3, Taxpayer filed with Commission A to adjust both its electric and its gas rates. The parties to the proceeding reached an agreement and, on or about Date 4, Taxpayer submitted a stipulation to Commission A for its approval. Commission A approved the stipulation on Date 5.

The stipulation provides that:

> 1) Taxpayer will seek a private letter ruling to determine if excess deferred taxes associated with excess tax over book depreciation that is subsequently reversed by accounting method changes relating to repair deductions and the capitalization of mixed service costs are protected by the normalization rules and subject to reversal under the ARAM; and that
>
> 2) Taxpayer will seek a private letter ruling from the IRS to determine whether post-Year 1 cost of removal is protected by the normalization rules and, if so, whether it is to be treated as a separate temporary difference or part of the overall depreciation temporary difference for purposes of ARAM amortization.

RULINGS REQUESTED

Taxpayer requests the following guidance:

1) Under the circumstances described above, is Taxpayer's electric distribution COR-related net DTL "protected" by the Normalization Rules?

2) If Taxpayer's electric distribution COR-related deferred tax is "protected," should that shortfall be treated as a discrete "protected" item or as part of the "protected" method/life difference?

3) Under the circumstances described above, is Taxpayer's gas distribution COR-related net DTA accumulated through the depreciation rate prior to Month 1 of Year 3 "protected" by the Normalization Rules?

4) If Taxpayer's gas distribution COR-related deferred tax accumulated through the depreciation rate prior to Month 1 of Year 3 is "protected," should that shortfall be treated as a discrete "protected" item or as part of the "protected" method/life difference?

5) Under the circumstances described above, is Taxpayer's gas distribution COR-related net DTL accumulated through the fixed estimated cash recovery after Month 1 of Year 3 "protected" by the Normalization Rules?

6) If Taxpayer's gas distribution COR-related net DTL accumulated through the fixed estimated cash recovery after Month 1 of Year 3 is "protected," should that shortfall be treated as a discrete "protected" item or as part of the "protected" method/life difference?

7) If Taxpayer's COR-related deferred tax shortfall is "protected," do the Normalization Rules permit Taxpayer to collect a shortfall any more rapidly than using the ARAM?

8) Do Taxpayer's depreciation-related ADFIT balances created pursuant to the Normalization Rules that are attributable to costs that were capitalized into the basis of depreciable assets prior to Taxpayer changing its method of accounting for those costs remain subject to the Normalization Rules after the change in method of accounting pursuant to which such costs were reclassified as current deductions?

LAW AND ANALYSIS

Section 168(f)(2) 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.

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 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. *See also* § 2.05(1) of Rev. Proc. 97-27, 97-27, 1997-1 C.B. 680 (the operative method change revenue procedure at the time Taxpayer filed its Form 3115, *Application for Change in Accounting Method*).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the period of limitation on assessment under § 6501(a). *Suzy's Zoo v. Commissioner*, 114 T.C. 1, 13 (2000), *aff'd*, 273 F.3d 875, 884 (9th Cir. 2001); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 912 (1983), *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968), *Spang Industries, Inc. v. United States*, 6 Cl. Ct. 38, 46 (1984), *rev'd on other grounds* 791 F.2d 906 (Fed. Cir. 1986). *See also Mulholland v. United States*, 28 Fed. Cl. 320, 334 (1993) (concluding that a court has the authority to review the taxpayer's threshold selection of a method of accounting *de novo*, and must determine, *ab initio*, whether the taxpayer's reported income is clearly reflected).

Sections 481(c) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into accounting in determining taxable income in the manner, and subject to the conditions, agreed to by the Service and a taxpayer. Section 1.446-1(e)(3)(i) authorizes the Service to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). *See also* § 5.02 of Rev. Proc. 97-27.

When there is a change in method of accounting to which § 481(a) is applied, § 2.05(1) of Rev. Proc. 97-27 provides that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Because of their similarity, we address requests 1, 3, and 5 together. For all of the COR-related amounts at issue in these requests, the amounts are not protected by the Normalization Rules. Generally, § 168(i)(9)(A) does not refer to COR. Moreover, there is no reference to an acceleration of taxes but only to a deferral. While COR may be a component of the calculation of the amount treated as book depreciation, it is a deduction under § 162 and has nothing to do with actual accelerated tax depreciation. While depreciation method and life differences are created and reversed solely through depreciation, such is not the case with COR. While the COR timing differences may often originate as a component of book depreciation, it reverses through the incurred COR expenditure.

Taxpayer's ruling request 8 pertains to the depreciation-related ADIT existing prior to the year of change (Year 6) for public utility property in service as of the end of the taxable year immediately preceding the year of change. Beginning with the year of change, the Year 6 Consent Agreement granted Taxpayer permission to change its (1) method of accounting for mixed service costs to recharacterize a substantial quantity of mixed service costs that Taxpayer had previously capitalized into depreciable assets as deductible costs (including additions to cost of goods sold) and (2) to depart from its book method for tax purposes electing to use for tax purposes larger units of property than used for book purposes which resulted in characterizing many projects that were capitalized for book purposes as deductible repairs for tax purposes.

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed by Taxpayer, and income for the year of change and the following taxable years must be determined under Taxpayer's new method of accounting as if the new method had always been used. *See* § 481(a); § 1.481-1(a)(1); and § 2.05(1) of Rev. Proc. 97-27. In other words: (1) Taxpayer's new method of accounting is implemented beginning in the year of change; (2) Taxpayer's old method of accounting used in the taxable years preceding the year of change is not disturbed; and (3) Taxpayer takes into account a § 481(a) adjustment in computing taxable income to offset any consequent omissions or duplications.

Accordingly, for public utility property in service as of the end of the taxable year immediately preceding the year of change (Year 6), the depreciation-related ADIT existing prior to the year of change for the changes in methods of accounting subject to the Year 6 Consent Agreement does not remain subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax methods of accounting in the year of change and subsequent taxable years.

Based on the foregoing, we conclude that:

1) Under the circumstances described above, Taxpayer's electric distribution COR-related net DTL is not "protected" by the Normalization Rules.

3) Under the circumstances described above, Taxpayer's gas distribution COR-related net DTA accumulated through the depreciation rate prior to Month 1 of Year 3 is not "protected" by the Normalization Rules.

5) Under the circumstances described above, Taxpayer's gas distribution COR-related net DTL accumulated through the fixed estimated cash recovery after Month 1 of Year 3 is not "protected" by the Normalization Rules.

Because these amounts in requests 1, 3, and 5 are not protected by the Normalization Rules, requests 2, 4, 6, and 7 are moot.

8) Taxpayer’s depreciation related ADFIT balances created pursuant to the Normalization Rules that are attributable to costs that were capitalized into the basis of depreciable assets prior to Taxpayer changing its method of accounting for those costs do not remain subject to the Normalization Rules after the change in method of accounting pursuant to which such costs were reclassified as current deductions.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

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

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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

cc:

Internal Revenue Service

Number: **202010002**
Release Date: 3/6/2020

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-113227-19
Date: December 3, 2019

In Re:

LEGEND:

Taxpayer	=
Parent	=
State A	=
State B	=
Commission	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=

Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Month 5	=
Month 6	=
Year 1	=
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Dear :

This letter responds to a request for a private letter ruling dated June 5, 2019, and submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (together, the "Normalization Rules") regarding the scope of the deferred tax normalization requirements and the appropriate methodology for the reduction of the accumulated deferred income tax ("ADIT") balance that decreases rate base computation when a net operating loss carryforward ("NOLC") exists. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer files a consolidated federal income tax return on a calendar year basis with its affiliates, including its Parent. Taxpayer uses the accrual method of accounting.

Parent is incorporated in State A, and Taxpayer is incorporated in State B. Parent is a water and wastewater utility company. Taxpayer is the affiliate that operates in State B. Prices charged by Taxpayer are set by Commission. Commission sets rates that Taxpayer may charge for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings (resulting in what are commonly referred to as "base rates") and infrastructure surcharge proceedings (resulting in surcharges that are added to base rates.)

The most recent two base rate changes resulting from general rate case authorizations by Commission affecting water and wastewater revenue requirements were effective in Month 1 Year 1 and Month 2 Year 2. The most recent three rate changes resulting from infrastructure surcharge authorizations by Commission were effective in Month 3 Year 3, Month 4 Year 4 and Month 4 Year 2. Taxpayer questions whether the rates set pursuant to the most recent infrastructure surcharge proceeding comply with the deferred tax normalization requirements.

Infrastructure surcharges are regulatory mechanisms to permit recovery of capital investments and results in adjustments to rates charged outside of a general rate case for specified costs and investments. Under State B statute and Commission rulemaking, eligible water corporations may petition Commission and utilize a Infrastructure System Replacement Surcharge ("Surcharge") to recover the costs of eligible water utility main replacements and relocations.

For both general rate case proceedings and Surcharge proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation and ADIT, and a recovery of operating expenses, including depreciation expense, property tax expense, and income tax expense. For Surcharge proceedings, rate base is determined based on incremental plant expenditures incurred during a historical measurement period (not necessarily 12 months) ending shortly before rates become effective, less accumulated book depreciation and ADIT computed as of a date subsequent to the date at which gross plant is computed and closer to (but preceding) the date that rates become effective. For Surcharge proceedings, operating expenses include 12 months of annualized depreciation expense on the incremental investment in the Surcharge proceeding and any property taxes that will be paid within 12 months of filing the Surcharge application.

The deferred tax normalization matters in this request arose during the Surcharge proceeding initiated by Taxpayer in Month 5 Year 2 and resulting in a Commission order on Date 1 (the "Surcharge Case"). The Surcharge resulting from the Surcharge Case became effective on Date 2. Some of the normalization matters addressed in this ruling request related to deductions and ADIT resulting from the consent agreement that Parent received from the Service on Date 3, on behalf of itself and various affiliates, including Taxpayer, with respect to changes in tax method of accounting for costs to repair and maintain tangible property and dispositions of certain tangible depreciable property ("Consent Agreement").

State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. A petition must be filed with the Commission for review and approval before an adjustment can be made to a water corporation's rates and charges to provide for the recovery of the costs associated with eligible infrastructure system replacements. A State B statute authorizes Commission to enter an order authorizing the water corporation to impose a Surcharge that is sufficient to recover appropriate pretax revenues. The State B statute defines the revenue requirement set in a Surcharge proceeding and provides that "appropriate pretax revenues" are the revenues necessary to produce net operating income equal to the water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements. . .” among other items. Taxpayer represents that Commission and the State B courts have interpreted this statute in a strict manner thereby limiting the costs eligible for recovery or to earn a return in a Surcharge proceeding and causing costs not eligible for ratemaking consideration in a Surcharge proceeding to only be eligible for recovery or return in the next base rate proceeding.

Taxpayer, per its petition filed with Commission on Date 4, sought to establish a Surcharge rate to provide for the recovery of actual costs for eligible infrastructure system replacements and relocations from Date 5 through Date 6, and estimated investment accounts for Date 7 through Date 8. During the course of the Surcharge case, Taxpayer provided Commission with actual expenditures for Month 5 and Month 6. The proposed Surcharge rate schedule reflected the pre-tax Surcharge revenues necessary to produce net operating income equal to Taxpayer’s weighted cost of capital multiplied by the original cost of the requested infrastructure replacements that are eligible for the Surcharge, reduced by net ADIT and accumulated depreciation associated with eligible infrastructure system replacements through Date 9. Taxpayer also sought to recover all state, federal and local income or excise taxes applicable to such Surcharge income and to recover all other Surcharge costs including annualized depreciation expense and property taxes due within 12 months.

The specific test period and service period information pertaining to the Surcharge Case is:

- Rates became effective Date 2
- Actual gross plant was based on additions of certain property placed in service from Date 5 through Date 8
- Accumulated depreciation on such assets was estimated through Date 9
- Estimated ADIT related to depreciation book/tax differences associated with such expenditures to the extent also capitalized for tax purposes was computed through Date 9
- Estimated ADIT related to repair book/tax differences associated with such expenditures to the extent not capitalized for tax purposes was computed through Date 9
- Recoverable operating expenses were estimated for the period beginning Date 10 and ending Date 9

In a Surcharge proceeding, replacement mains and associated valves and hydrants comprise the plant assets included in rate base and result in the accumulated depreciation reducing rate base and the recoverable depreciation expense. The expenditures for replacement mains and associated valves addressed in a Surcharge proceeding are capitalizable for regulatory accounting purposes, but may result in a repair deduction for tax purposes or depreciable plant for tax purposes. The ADIT balance reducing rate base in a Surcharge proceeding is caused by depreciation-related and repair-related book/tax differences.

The key issues in the Surcharge case and, thus, in this ruling request, pertain to whether the tax effect of an NOLC must, pursuant to the normalization requirements, decrease the ADIT reduction to rate base related to the expenditures in the Surcharge case and, if so, the methodology to determine the amount of the NOLC adjustment subject to the normalization requirements. The return on rate base is based on the pre-tax rate of return authorized in the most recent rate order resulting from a general rate proceeding.

In the course of the Surcharge Case, Taxpayer and other participants in the proceeding analyzed the expenditures for which Taxpayer sought recovery via the Surcharge and debated the proper regulatory treatment of Taxpayer's NOLC and tax loss incurred through the rate base determination date of the Surcharge case with respect to the costs incurred that are recoverable in the Surcharge case. The revenue requirement approved in Commission's order issued on Date 1 was lower than the revenue requirement sought by Taxpayer and is entirely attributable to differing ADIT calculations with respect to the NOLC and the resulting effects on rate base and allowed return. The approved revenue requirement in the Surcharge case was based on a rate base computation that reflects the gross ADIT liabilities associated with depreciation-related and repair-related book/tax differences, but did not reflect an ADIT asset for any portion of Taxpayer's NOLC as of the date that rate base was determined (Date 9) , including the tax loss resulting from the infrastructure expenditures addressed in the Surcharge Case.

On a consolidated basis, Parent incurred tax losses in various years from Year 5 to Year 1 and, as of Date 11, had an NOLC of approximately $a. On a separate company basis, Taxpayer incurred tax losses in various tax years from Year 5 – Year 1 and, as of Date 11, had a separate company NOLC of approximately $b. For Year 2, Parent (on a consolidated basis) and Taxpayer (on a separate company basis) estimate that taxable income was earned and, thus, NOLC was utilized.

The revenue requirement related to the Surcharge Case is approximately $c (pursuant to the rate order). Taxpayer asserts that the revenue requirement should have been computed to be $d. The difference in the revenue requirement computations relates entirely to the exclusion of Taxpayer's NOLC from rate base. As of the date of the rate base determination, none of the Surcharge revenues had been billed to customers and, thus, as of such date, a taxable loss of approximately $e had been incurred with respect to the plant-related expenditures with rates set by the Surcharge Case.

During the loss years resulting in Taxpayer's NOLC estimated as of the end of the test period for the Surcharge Case, separate company deductible depreciation-related book/tax differences were approximately $f and separate company deductible repair-related book/tax differences were approximately $g (plus the § 481(a) adjustment with respect to the tax accounting method changes subject to the Consent agreement deducted in Year 5 of approximately $h.

The NOLC reflected in ratemaking for the base rate case proceeding with rates effective in Month 2 Year 2 was based on the estimated NOLC as of the end of Year 4 of $i, including an estimated Year 4 tax loss of $j. The actual Year 4 tax loss reported on the Year 4 tax return was $k. The excess of the actual Year 4 tax loss over the estimated Year 4 tax loss of $l has yet to be reflected in ratemaking.

On Date 12, Taxpayer filed an Application for Rehearing and Motion to Defer Ruling, asking the Commission for the time to seek a private letter ruling form of guidance from the Service to address any uncertainties regarding the application of the deferred tax normalization requirements to the rate base treatment of the NOLC-related ADIT asset in computing the Surcharge case revenue requirement. On Date 13, the Commission denied Taxpayer's request for rehearing. Taxpayer filed a notice of appeal by Date 14, that initiated an appeal of the order in the Surcharge case to the State B Court of Appeals. Taxpayer anticipates receiving a private letter ruling from the Service prior to the State B Court of Appeals issuing a final opinion in Taxpayer's appeal of the Commission denial of Taxpayer's Motion for Rehearing. If the Service rules that the Commission's decision in Taxpayer's Surcharge case ordered a method of regulatory accounting that is inconsistent with the deferred tax normalization requirements, Taxpayer believes that the Commission and Taxpayer would be procedurally able to correct the revenue requirement in a manner that compensates Taxpayer for any foregone revenue requirement relative to ADIT and rate base computations that comply with the normalization requirements.

Because Taxpayer is concerned that the order issued by Commission as part of the Surcharge case on Date 1, and the prices that became effective on Date 2, are inconsistent with the deferred tax normalization requirements, Taxpayer submitted a letter to the Service on Date 14 intended to provide the notification pursuant to § 1.167(l)-1(h)(5) of the Regulations.

As noted, on Date 3, Taxpayer's parent corporation received the Consent Agreement from the Internal Revenue Service granting certain of its subsidiaries, including Taxpayer, permission to change their (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162 of the Internal Revenue Code, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property. These changes in methods of accounting were effective for the taxable year beginning Date 15, and ended Date 16 (the "year of change").

These changes in methods of accounting resulted in an overall net negative § 481(a) adjustment for Taxpayer as stated in the Consent Agreement. This overall net negative § 481(a) adjustment consists of a net negative § 481(a) adjustment for the repair and maintenance change in method of accounting and a net positive § 481(a) adjustment for the disposition change in method of accounting.

The Service's consent to the above changes in methods of accounting is subject to several terms and conditions stated in the Consent Agreement. Condition nine of the Consent Agreement requires that if any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A): (A) a normalization method of accounting (within the meaning of § 168(i)(9), former § 168(e)(3)(B), or former § 167(l)(3)(G), as applicable) must be used for the public utility property subject to the Form 3115; (B) as of the beginning of the year of change, the taxpayer must adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the Form 3115; and (C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer must provide a copy of the Form 3115 (and any additional information submitted to the Service in connection with such Form 3115) to any regulatory body having jurisdiction over the public utility property subject to the Form 3115. See page 6 of the Consent Agreement.

Based on Taxpayer's interpretation of this condition in the Consent Agreement, Taxpayer has applied the normalization requirements to its repair-related and disposition-related deferred tax computations in rate proceedings since the year of change.

Prior to the year of change (Year 5), Taxpayer depreciated public utility property that was in service as of the end of the taxable year immediately preceding the year of change using different book and tax methods and lives. As a result, an amount of ADIT subject to the normalization requirements was recorded prior to the above changes in methods of accounting for repairs and dispositions (depreciation-related ADIT).

Differing assertions were made as part of the Surcharge Case. Ultimately the Commission in its final order determined that because there was not an NOL expected to be generated in Year 4, no portion of the NOLC deferred tax asset can be associated with the Surcharge property.

RULINGS REQUESTED

1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).

2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10)

must comply with the normalization method of accounting within the meaning of § 168(i)(9).

3) For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax method of accounting.

4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer's Consent Agreement, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting for dispositions permitted in Taxpayer's Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the

revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the text period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) If the Service (a) rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, but (b) does not grant ruling # 9 in accordance with Taxpayer’s analysis, Taxpayer requests that the Service instead rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences during the test period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method but only to the extent that the NOLC has not reduced depreciation-related ADIT in rate base computation in another rate proceeding with prices still in effect.

11) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) If the Service does not rule as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is subject to the normalization requirements, Taxpayer requests that the Service also rule: Under

the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect the portion of the Surcharge Case test period NOL which would not have arisen had Taxpayer not reported the depreciation-related book/tax difference or repair-related book/tax difference permitted in Taxpayer's Consent Agreement with respect to expenditures with ratemaking determined pursuant to the Surcharge Case, by an amount that is no less than the amount computed using the With-and-Without Method. If, instead, the Service rules as Taxpayer has requested with respect to issue # 5, ruling request # 12 would be moot.

LAW AND ANALYSIS

Section 168(f)(2) 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.

Section 168(i)(10) defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in § 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body that has the power to approve such rates, even if the regulatory body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), expand the definition of regulated rates. The expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former § 167. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Thus, for purposes of applying the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

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 (referred to as the “Consistency Rule”).

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.

Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements of former § 167(l) with respect to public utility property defined in former § 167(l)(3)(A) 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.

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. *See also* § 2.05(1) of Rev. Proc. 97-27, 97-27, 1997-1 C.B. 680 (the operative method change revenue procedure at the time Taxpayer filed its Form 3115, *Application for Change in Accounting Method*).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the period of limitation on assessment under § 6501(a). *Suzy's Zoo v. Commissioner*, 114 T.C. 1, 13 (2000), *aff'd*, 273 F.3d 875, 884 (9th Cir. 2001); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 912 (1983), *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968), *Spang Industries, Inc. v. United States*, 6 Cl. Ct. 38, 46 (1984), *rev'd on other grounds* 791 F.2d 906 (Fed. Cir. 1986). *See also Mulholland v. United States*, 28 Fed. Cl. 320, 334 (1993) (concluding that a court has the authority to review the taxpayer's threshold selection of a method of accounting *de novo*, and must determine, *ab initio*, whether the taxpayer's reported income is clearly reflected).

Sections 481(c) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into accounting in determining taxable income in the manner, and subject to the conditions, agreed to by the Service and a taxpayer. Section 1.446-1(e)(3)(i) authorizes the Service to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). *See also* § 5.02 of Rev. Proc. 97-27.

When there is a change in method of accounting to which § 481(a) is applied, § 2.05(1) of Rev. Proc. 97-27 provides that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Regarding ruling requests 1 and 2, the key factors in determining whether property is public utility property are that (1) the property must be used predominantly in the trade or business of the furnishing or sale of, inter alia, water and wastewater; (2) the rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof; and (3) the rates so established or approved must be determined on a rate-of-return basis. State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. These infrastructure system replacements will be predominantly used in the trade or business of the furnishing or sale of water and wastewater and therefore, it will possess the first of the three characteristics. Moreover, as a regulated public utility subject to the jurisdiction of federal or state law, including the ratemaking jurisdiction of the State B commission, the second requirement is met. Lastly, as evidenced by the facts, these rates are determined on a rate-of-return basis. After establishing that this involves public utility property, the law makes clear that the depreciation deduction determined under § 168 shall not apply to any public utility property if the taxpayer does not use a normalization method of accounting. The normalization regulations require a taxpayer to credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account.

Taxpayer's ruling request 3 pertains to the depreciation-related ADIT existing prior to the year of change ( ) for public utility property in service as of the end of the taxable year immediately preceding the year of change. Beginning with the year of change, the Consent Agreement granted Taxpayer permission to change its (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property.

As stated previously, condition nine of the Consent Agreement provides that if any item of property subject to the Form 3115 is public utility property within the meaning of § 168(i)(10), a normalization method of accounting (within the meaning of § 168(i)(9)) must be used for such public utility property. Public utility property (within the meaning of § 168(i)(10)) is a depreciable asset. Consequently, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years.

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed by Taxpayer, and income for the year of change and the following taxable years must be determined under Taxpayer's new method of accounting as if the new method had always been used. *See* § 481(a); § 1.481-1(a)(1); and § 2.05(1) of Rev. Proc. 97-27. In other words: (1) Taxpayer's new method of accounting is implemented beginning in the year of change; (2) Taxpayer's old method of accounting used in the taxable years preceding the year of change is not disturbed; and (3) Taxpayer takes into account a § 481(a) adjustment in computing taxable income to offset any consequent omissions or duplications.

Accordingly, for public utility property in service as of the end of the taxable year immediately preceding the year of change ( ), the depreciation-related ADIT existing prior to the year of change for the changes in methods of accounting subject to the Consent Agreement does not remain subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax methods of accounting in the year of change and subsequent taxable years.

As stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

Similarly, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

Regarding ruling request 6, § 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. 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)(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). In this case, the transaction involves a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting. The depreciation-related ADIT existing immediately prior to a transaction considered a retirement for regulatory accounting purposes but not treated as a disposition for federal income tax purposes continues to be subject to the normalization requirements because adjusted tax basis is not affected and the § 168(a) depreciation deductions continue.

For ruling request 7, as stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. Accordingly, the ADIT resulting from the disposition-related § 481(a) adjustment and related to the restored tax basis of public utility property that was treated as disposed under the old method of accounting but is not treated as disposed under the new method of accounting is subject to the normalization method of accounting within the meaning of § 168(i)(9).

Regarding ruling requests 8, 9, and 11, generally, Taxpayer is arguing that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax during the Surcharge Case test period due to the presence of the NOLC. The normalization requirements pertain **only** to deferred income taxes for public utility property resulting from the use of accelerated depreciation for tax purposes and the use of straight-line depreciation for establishing cost of service and reflecting the operating results in regulated books of account. Generally, amounts that do not actually defer tax because of the existence of an NOL need to be reflected as offsetting entries to the ADIT account to show the portion of tax losses which did not actually defer tax due to accelerated depreciation.

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. 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 ADIT asset resulting from the NOLC should be included in rate base, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

Section 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 suggested 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.

Taxpayer also raises the issue of the computation of the amount by which depreciation-related Taxpayer’s NOLC as of the rate base determination date for the Surcharge Case must be included in rate base. This focuses on whether the NOLC taken into account in the Surcharge Case is limited to depreciation-related book/tax differences related to expenditures reflected in the Surcharge Case or must also reflect the full net increase in depreciation-related NOLC occurring since the rate base determination date of the immediately preceding base rate proceeding. In this case, based on the State B statute, the revenue requirement of a Surcharge Case is limited to the following income tax amounts: ADIT associated with property-related costs for property with rates set by the Surcharge Case and income taxes applicable to the Surcharge Case revenue requirement. The normalization requirements do not require that all incremental NOLC arising since the most recent general rate proceeding must be reflected in an interim (here a Surcharge) proceeding. Instead, the normalization requirements permit an increase in NOLC resulting from non-Surcharge Case public utility property to be disregarded for the Surcharge Case and considered in the next rate proceeding that reflects the depreciation expense and rate base inclusion of the public utility property resulting in the depreciation-related book/tax differences included in the NOLC.

Based on the foregoing, we conclude that:

1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).

2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10) must comply with the normalization method of accounting within the meaning of § 168(i)(9).

3) For any public utility property within the meaning of § 168(i)(10) of the Code as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer’s Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) of the Code after implementation of the new tax method of accounting.

4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer’s Consent Agreement, the ADIT resulting from the repair-related § 481(a)

adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer’s Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer’s tax method of accounting for dispositions permitted in Taxpayer’s Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer’s Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the text period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) Ruling request 10 is moot because we grant ruling 9 in accordance with Taxpayer’s analysis.

11) Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) Ruling request 12 is moot because we rule as Taxpayer requests with respect to ruling request 5.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

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

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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