

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**Docket Nos. UE-111048 and UG-111049  
Puget Sound Energy, Inc.'s  
2011 General Rate Case**

**PUBLIC COUNSEL DATA REQUEST NO. 444**

**PUBLIC COUNSEL DATA REQUEST NO. 444:**

**Re: Rebuttal Testimony of Mr. Marcelia, Exhibit No. MRM-14T**

Regarding Mr. Marcelia's Rebuttal Testimony, page 58, lines 13-15, have there been any IRS rulings that excluding the NOL carry-forward from rate base would be a violation of the normalization requirements of the tax code? If so, please provide copies of all such IRS rulings of which the Company is aware.

**Response:**

Puget Sound Energy, Inc. ("PSE") is aware of three rulings in which the IRS addresses normalization and net operating loss ("NOL") carryforwards. The three rulings, along with Treasury Regulation §1.167(l)-1(h)(1)(iii), support PSE's position in this filing. Attached as Attachment A to PSE's Response to Public Counsel Data Request No. 444, please find a copy of these three rulings.

**ATTACHMENT A  
TO PSE'S RESPONSE TO PUBLIC COUNSEL DATA NO. 444**

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Source: IRS Documents > PLRs/TAMs and Other Advice > 1988 > PLR 8818040

**PLR 8818040**

**Section 168 -- ACRS Depreciation**

**UIL Number(s) 0168.08-02**

**Date: February 9, 1988**

Refer Reply to: CC:C:2:6 - TR-31-06461-87

**LEGEND:**

**Commission = \* \* \***

Dear \* \* \*

This is in response to your request for a letter ruling dated November 23, 1987, submitted on your behalf by your authorized representative. You have asked us to rule whether, to the extent that the use of the Accelerated Cost Recovery System (ACRS) in 1986 and prior years in determining the taxpayer's depreciation expense for Federal income tax purposes contributed to a net operating loss (NOL) carryover from 1985 and 1986 to 1987, the taxpayer's use of the Federal statutory income tax rate in effect in 1987 for purposes of computing the deferred tax expense in its regulated books of account for the year 1987 will be consistent with the normalization requirements under sections 167 and 168 of the Internal Revenue Code and the Income Tax Regulations promulgated thereunder.

The taxpayer is incorporated under the laws of the State of \* \* \*, has its principal executive offices at \* \* \*, and files its returns with the Internal Revenue Service in \* \* \*. The taxpayer files its returns using a calendar year. The Internal Revenue Service (IRS) district office in \* \* \* has examination jurisdiction over the taxpayer's return.

The taxpayer is a regulated public utility transmitting and distributing electric power. It has been represented under penalty of perjury that the Commission has been apprised of the taxpayer's ruling request and has no objection to the issuance of a ruling on the request.

As a public utility, the taxpayer is required to use the normalization method of accounting as a condition to its use of accelerated depreciation methods, including ACRS, for Federal income tax purposes. Accordingly, the taxpayer records deferred tax expense for financial statement and regulatory purposes pursuant to the provisions of sections 167 and 168 of the Code and the regulations thereunder. Hereinafter, the accelerated depreciation that the taxpayer is required to normalize is referred to as ACRS.

The amount of Federal income tax expense that the taxpayer recorded for financial statement purposes for 1986 and prior years was greater than the Federal income taxes actually paid. The additional recorded Federal income taxes (deferred taxes) resulted, in part, from a significant amount of property placed in service in 1985, which increased the depreciation deduction for Federal income tax purposes. However, the taxpayer did not realize the entire tax benefit from the ACRS depreciation claimed in 1985 and 1986 because the depreciation resulted in a NOL carryover to 1987. Therefore, in order to reflect the tax benefit of the NOL carryover to 1987, the taxpayer reduced its deferred Federal income tax expense and liability for 1985 and 1986 for financial reporting purposes. The net effect of this accounting in 1985 and 1986 was to record no deferred taxes applicable to the amount of ACRS depreciation that produced no current tax savings but rather caused or increased taxpayer's

NOL carryover to 1987. The taxpayer only recorded deferred taxes applicable to ACRS when and to the extent that the use of ACRS produced an actual tax deferral.

The taxpayer will have taxable income in 1987 in excess of the NOL carryover from 1986. Consequently, the ACRS depreciation that was claimed in 1985 and 1986, but did not then produce a tax benefit, will produce a benefit in 1987 when the NOL is utilized. Accordingly, for 1987 the taxpayer proposes to record the deferred Federal income tax expense resulting from the use of the NOL carryover from 1986 at the rate of 39.95%, the effective income tax rate for 1987. This rate is lower than the 46 percent rate in effect during 1986 and the prior years when the ACRS depreciation was originally deducted on the taxpayer's Federal income tax return.

Section 168(f)(2) of the Code generally requires the use of the normalization method of accounting with respect to regulated public utility property in order for the public utility to be allowed to use ACRS depreciation for Federal income tax purposes.

Section 168(i)(9)(A) of the Code sets forth the normalization accounting requirements. This section provides that the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for rate making purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. In addition, if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(1)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 1.167(1)-1(h)(1)(i) of the regulations provides that a taxpayer uses a normalization method of regulated accounting if the taxpayer makes adjustments to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

Section 1.167(1)-1(h)(1)(iii) of the regulations provides that, except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different methods of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (1) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a section (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Under the regulations, the amount of deferred taxes is computed using a "with and without" methodology. (That is, deferred taxes equal the excess of taxes due without ACRS over the taxes due with ACRS). Where taxes computed with ACRS produce a NOL carryover, the amount and time of the deferral is left to the discretion of the Internal Revenue Service.

The taxpayer maintains that where the computation utilizing ACRS results in a NOL, the deferral is appropriately made at the time the taxpayer realizes an actual tax benefit from the use of ACRS. The taxpayer will realize the benefit of the NOL attributable to the accelerated depreciation in 1987. Therefore, the taxpayer should record the deferred taxes in 1987. We conclude that this approach is consistent with the normalization requirements under sections 167 and 168 of the Code.

With respect to the amount of the deferral, the Federal statutory income tax rates in effect in 1987 for calendar year taxpayers, pursuant to the Tax Reform Act of 1986, can reasonably be combined to result in an effective rate of 39.95 percent. See section 3 of Rev. Proc. 88-12, 1988-8 I.R.B. \_\_\_\_\_. This is lower than the 46 percent rate in effect when the NOL was incurred. Because the deferred taxes are being recorded in 1987, it is appropriate to utilize the effective tax rate for that year. We note that this approach is consistent with generally accepted accounting principles as set forth in APB Opinion No. 11, Accounting for Income Taxes. Regarding NOL's, the APB Opinion provides that if loss

carryforwards are realized in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit account should be reinstated at the then current tax rates. We conclude that the taxpayer's methodology satisfies the normalization requirements of sections 167 and 168 of the Code.

Accordingly, to the extent that the use of ACRS depreciation in 1986 and prior years in determining depreciation expense for Federal income tax purposes contributed to a NOL carryover from 1986 to 1987, the taxpayer's use of the effective tax rate for 1987 (39.95 percent for calendar year taxpayers) in computing the deferred Federal income tax expense on its regulated books of account for the year 1987 will be consistent with the normalization requirements of sections 167 and 168 of the Code and the regulations thereunder.

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

A copy of this private letter ruling is being sent to your authorized representative in accordance with the power of attorney on file with this office.

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 is consummated.

Sincerely yours,

James F. Malloy  
Director, Corporation  
Tax Division

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Contact us at <http://www.bna.com/contact/index.html> or call 1-800-372-1033

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Source: IRS Documents > PLRs/TAMs and Other Advice > 1989 > PLR 8903080

**PLR 8903080**

**Section 168 -- ACRS Depreciation**

**UIL Number(s) 0046.07-02, 0167.00-00, 0168.00-00**

**Date: October 26, 1988**

Refer Reply to: CC:P&SI:6 - TR-31-3458-88  
In re: Private Letter Ruling Request -

**LEGEND:**

**Taxpayer = \* \* \***

**Plan = \* \* \***

**Station = \* \* \***

**Commission = \* \* \***

**Commission Staff = \* \* \***

**a = \* \* \***

**b = \* \* \***

**c = \* \* \***

**d = \* \* \***

**e = \* \* \***

**f = \* \* \***

**g = \* \* \***

**h = \* \* \***

**i = \* \* \***

**j = \* \* \***

**k = \* \* \***

**l = \* \* \***

**m = \* \* \***

**n = \* \* \***

**o = \* \* \***

**Docket X = \* \* \***

**State Y = \* \* \***

Dear \* \* \*

We received your private letter ruling request dated July 26, 1988, and all subsequently filed data. You are requesting a ruling on four issues as to whether the normalization of the investment tax credit (the "ITC") and accelerated depreciation, as presented before Commission for cost of service purposes, meet the normalization requirements of the Internal Revenue Code. Specifically you have requested the following rulings with respect to Plan:

1. The cost of service treatment, for Station ITC, of the ratable amortization of ITC credited to Account 186 for the period a through b, and the increase in rate base for the Account 186 balance and the subsequent amortization over c years of the Account 186 balance at b, is in compliance with the normalization requirements of ITC under section 46(f)(2) of the Code.

2. The cost of service treatment of Station deferred federal income taxes due to accelerated depreciation charged to Account 186 for the period a through b, and the increase in rate base for the balance in Account 186 and the subsequent amortization over c years of the deferral account balance at b, is in compliance with the normalization requirements for accelerated depreciation under section 168(e)(3) of the 1954 Code.
3. The calculation of the revenue requirements of the test year and the phase-in plan years, using the reduction in rate base for the balances of accumulated depreciation and deferred income taxes, as calculated in accordance with section 1.167(1)-1(h)(6) of the Income Tax Regulations, and the deferral of a portion of the return and the subsequent recovery of that deferral by the end of Plan period is in compliance with normalization requirements of section 168(e)(3) of the 1954 Code.
4. The methodology used in calculating normalized depreciation when a net operating loss (the "NOL") is carried back to years in which the federal income tax rates were higher than in the year of the NOL, to the items that gave rise to deferred taxes including normalized depreciation in the year of the NOL and the subsequent flowback of the deferred taxes related to such normalized depreciation is in compliance with the requirements of section 203(e) of the Tax Reform Act of 1986 (the "Act") and section 1.167(1)-1(h)(iii) of the regulations for cost of service purposes.

You have made the following representations:

Taxpayer is a regulated public utility company and its property is "public utility property" within the meaning of sections 46(c)(3), 46(f)(5), and 167(1)(3) of the Code. It is engaged in the generation, transmission, distribution and sale of electric energy and the distribution and sale of natural gas in State Y. Taxpayer's utility operations are, for purposes of this ruling, subject to the rate and regulatory jurisdiction of Commission. Records are maintained in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

Taxpayer, in joint tenancy, owns approximately d percent of Station, with the balance owned by two unrelated parties. Taxpayer has control over the operation of Station and the parties share operating and maintenance costs and electricity generated in proportion to their ownership interests. On e, the Nuclear Regulatory Commission (NRC) granted Taxpayer a full power operating license and on a, Station was synchronized to the power grid and began supplying electricity to the Taxpayer's system. a was established by Commission as the commercial operating date (in-service date) of Station for accounting purposes.

The inclusion of the cost of Station in rate base under traditional ratemaking would result in a substantial increase in electric rates. Therefore, to mitigate the effect of a large one-time rate increase, Taxpayer filed with Commission a long-term phase-in plan to gradually increase electric rates to reflect the cost of Station.

Plan, as proposed in Docket X, includes a deferred return phase-in concept, under which Taxpayer will delay realization of a cash return on a portion of the capital associated with Taxpayer's investment in Station. This results in reduced revenues (below the revenue requirements) in the early portion of the phase-in period and increased revenues (above the revenue requirements) during the later portion of the phase-in period. Plan also includes a provision for the use of mirror construction work in progress (CWIP),<sup>1</sup> and recognition of declining Station revenue requirements over Plan period since the rate base and revenue requirements associated with Station will decrease substantially due to accumulated depreciation and deferred income taxes resulting from accelerated tax depreciation.

A deferred asset account, pursuant to Commission order, is used to accumulate expenses<sup>2</sup> related to Station and a carrying charge thereon for the period beginning with the in-service date of Station and extending to the beginning of the period in which the cost of Station will begin being reflected in customer's rates (deferral period) pursuant to a rate order. During the deferral period, Taxpayer is recording these expenses in its financial statements, and is simultaneously deferring all of these expenses, including book depreciation expense and the related federal income tax consequences, into the deferred asset account. Consistent with the deferral of depreciation, Taxpayer is also recording and simultaneously deferring, into the deferred asset account, the ratable portion of the amortization of ITC for the same period. Carrying charges are calculated on amounts in this account (excluding deferred amortization of ITC) and on plant not yet in rate base (net of accumulated depreciation and deferred income taxes) and will continue to be accrued until such time as the deferred expenses and related carrying charges are reflected in rates. Beginning with the effective date of the rate order, the deferred asset account will be amortized for ratemaking purposes over the remaining regulatory life of

the plant.

Revenue requirements in the first year of Plan are determined using the cost of service, as represented by a historical test year, adjusted for changes expected to occur during the first full year that the proposed rates will be in effect. Adjustments to the test year include pro-forma adjustments to reflect the operating expenses and the capital costs of Station and the deferred asset account. The test year's revenue requirements are used as a starting point for determining the first year and subsequent phase-in years' rate increases. These revenue requirements, for each year of Plan, are then reduced to reflect (1) the "customer loan repayment" resulting from mirror CWIP, and (2) the declining Station rate base which results primarily from accumulated depreciation and deferred income taxes and are increased to reflect estimated Station capital additions.

Revenue requirements not met by rate increases each year are deferred. A carrying charge is applied to the deferred return until recovered in rates. Deferred return and associated carrying charges are recovered by the end of the g-year phase-in plan period.

#### ISSUE NO. 1 (ITC AMORTIZATION)

For federal income tax purposes, pursuant to an election made under section 46(d) of the Code, ITC has been claimed on Station using "Qualified Progress Expenditure" methodology. Company has made a timely election under section 46(f)(2) for ratable flow through of ITC to cost of service. Section 38 provides for investment credit against the tax as determined under section 46(a). Section 46(c) defines qualified investment for purposes of determining the base upon which to compute the credit and section 46(c)(3)(B) defines "public utility property" as

(. . . property used predominantly in the trade or business of the furnishing or sale of -

(i) electrical energy, water, or sewage disposal services

(ii) gas through a local distribution system, or

(iii) telephone service . . . ,

if the rates for such furnishing or sale, as the case may be, have been established or approved by . . . a public service or public utility commission.

Section 46(d)(1) of the Code provides that a taxpayer upon making an election, can include as "qualified investments" certain "Qualified Progress Expenditures" as defined under section 46(d)(3).

Section 46(f) of the Code provides for limitations regarding regulated companies. Section 46(f)(1) provides a general rule that disallows the tax credits, otherwise allowable by section 38 for "public utility property" if for rate making purposes, such ITC is used to reduce the taxpayer's cost of service or to reduce the taxpayer's rate base (unless such rate base reduction is restored not less rapidly than ratably over the property's useful life for ratemaking purposes).

Section 46(f)(2) of the Code provides an exception to the general rule upon election, but states that

(. . . no credit determined under subsection (a) shall be allowed by section 38 with respect to any . . . public utility property (as defined in paragraph (5)) of the taxpayer -

(A) COST OF SERVICE REDUCTION. - If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection), or

(B) RATE BASE REDUCTION. - If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection).

Section 46(f)(5) of the Code states that public utility property for the purposes of this subsection means public utility property within the meaning of subsection (c)(3)(B) (described above).

Section 46(f)(6) of the Code defines "ratable portion" as the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account.

Section 1.46-6(g)(2) of the regulations states:

What is 'ratable' is determined by considering the period of time actually used in computing the



taxpayer's regulated depreciation expense for the property for which a credit is allowed. "Regulated depreciation expense" is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods) units of production, or machine hours and shall be determined in accordance with the individual useful life system or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of restoring, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the number of such units. . . . Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

Section 46(f)(10) of the Code concerns the use of inconsistent estimates and projections for purposes of meeting the requirements of sections 46(f)(1) and sections 46(f)(2) and states in part:

(A) IN GENERAL. - One way in which the requirements of paragraph (1) or (2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of paragraph (1) or paragraph (2), as the case may be.

(B) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS. - The procedures and adjustments which are to be treated as inconsistent for purposes of subparagraph (A) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit allowable by section 38 unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The ratable amortization of ITC and deferral of such amount into the deferred asset account for regulatory purposes is in compliance with section 46(f)(2) of the Code and section 1.46-6(g)(2) of the regulations, in so far as Taxpayer's cost of service for ratemaking purposes and its regulated books of account are not reduced by more than a ratable portion of the ITCs. By (1) recording book depreciation, the tax consequences of book depreciation and a ratable portion of the related ITC (which reflects the period of time used in computing depreciation expense for regulatory purposes), by (2) simultaneously deferring such amounts into a deferred asset account and by (3) subsequently amortizing the account for regulatory purposes, Taxpayer has used the same period of time for amortization of the ITC as that which is used in computing depreciation expense for purposes of reflecting operating results in its regulated books of account.

The base to which Taxpayer's rate of return for ratemaking purposes is applied is not reduced by reason of any portion of the credit in so far as the ITC does not reduce rate base and the ratable portion of the credit deferred in the asset account does not reduce the base on which carrying charges are computed.

#### ISSUES NO. 2 AND 3. (ACCELERATED DEPRECIATION NORMALIZATION)

For federal income tax purposes, Station will be classified as g-year public utility property under the Accelerated Cost Recovery System (ACRS). Beginning in h, the year in which Station was placed in service, Taxpayer calculated its tax depreciation deduction on i percent of its share of Station's tax basis and claimed that amount as a current deduction on its federal income tax return in the computation of taxable income. In accordance with the Commission order, Station is being depreciated for regulatory and for book purposes at an annual rate of j percent. This rate is composed of k percent (1 years) representing the book life of Station plus a component of m percent for interim retirements. Book depreciation on Station began on a, the in-service date of the plant for accounting purposes. Deferred federal income taxes were and will continue to be provided each year on the difference between the depreciation for federal income tax purposes and the depreciation taken into account for book purposes computed on the tax basis of Station.

Section 167(a) of the Code provides as a deduction a reasonable allowance for depreciation of property used in trade or business or held for the production of income and states that ". . . the deduction allowable under section 168 shall be deemed to constitute the reasonable allowance

provided by this section . . ."

Section 203 provides the effective dates and general transition rules with respect to implementing the provisions of section 201 of the Act which concern section 168 of the Code (ACRS). Section 203(a)(1) (A) states that ". . . the amendments made by section 201 shall apply to property placed in service after December 31, 1986, in taxable years ending after such date." Section 203(b)(1) states that:

In general the amendments made by section 201 shall not apply to -

(A) any property which is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract which was binding on March 1, 1986,

(B) property which is constructed or reconstructed by the taxpayer if -

(i) the lesser of (I) \$1,000,000 or (II) 5 percent of the cost of such property has been incurred or committed by March 1, 1986, and

(ii) the construction or reconstruction of such property began by such date, or

(C) an equipped building or plant facility if construction has commenced as of March 1, 1986, pursuant to a written specific plan and more than one-half of the cost of such equipped building or facility has been incurred or committed by such date.

Pursuant to section 203(b) of the Act, Station qualifies as "transition property" for purposes of ACRS depreciation and the ITC, subject to section 168 of the 1954 Code (recovery property) provisions that generally apply to property placed in service before 1987. In accordance with section 168(c)(2)(C) of the 1954 Code, Station is being depreciated over g years using ACRS methodology (Asset guideline class 49.12 - Electric Utility Nuclear Production Plant).

Section 168(e)(3) of the 1954 Code provides a special rule for public utility property which disallows ACRS depreciation unless the taxpayer uses a normalization method of accounting:

(A) IN GENERAL. - The term 'recovery property' does not include public utility property (within the meaning of section 167(1)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) USE OF NORMALIZATION METHOD DEFINED. - For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property -

(i) the taxpayer must, 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, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(1)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(C) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC. -

(i) IN GENERAL. - One way in which the requirements of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).

(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS. - The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall 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 under subparagraph (B)(ii) 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 1.167(1)-1(a)(1) of the regulations in discussing the scope of section 167(1) states, in part:

(. . . The normalization requirements of section 167(1) with respect to public utility property defined in section 167(1)(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 section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(1) 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. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. . . .

Section 1.167(1)-1(h)(1)(i) of the regulations states in part that a taxpayer uses a normalization method of regulated accounting with respect to public utility property -

(a) If the same method of depreciation (whether or not a subsection (1) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(b) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (a) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different method of depreciation.

Section 1.167(1)(1)(iii) of the regulations quantifies the normalization when it states:

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (1) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

The cost of service treatment of deferred federal income taxes is in compliance with section 168(e)(3) of the 1954 Code and section 1.167(1)-1(h)(1)(i)(a) and (b) of the regulations in so far as Taxpayer properly makes additions to a reserve that reflect the deferral of the federal income tax liability that will result from the use of an accelerated method of depreciation (ACRS) for federal income tax purposes and the use of straight line depreciation for regulatory purposes. By (1) recording book depreciation and the tax consequences of book depreciation, by (2) simultaneously deferring such amounts into a deferred asset account and by (3) subsequently amortizing the account for regulatory purposes, the same method and period for depreciation will be used to compute both the tax expense and depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in Taxpayer's regulated books of account; and identical values will be used in determining depreciation expense, tax expense, deferred taxes and rate base. Amounts that have not yet been recovered in rates, based on revenue requirements in any year, are deferred in an asset account for future recovery and continue to earn a carrying charge until reflected in rates during both the deferral period and the subsequent Plan years. The use of this methodology results in Taxpayer receiving the same revenues on a present value basis as it would have received had a traditional one-time rate increase been granted on the in-service date of Station.

#### ISSUE NO. 4 (DEFERRED TAXES - NOL CARRYBACK)

Taxpayer incurred a net operating loss (the "NOL") for tax purposes in h. In addition, it estimated that there would be an NOL for tax purposes in n. The federal tax rates in these years are 39.95 percent and 34 percent, respectively. In the estimates presented for ratemaking purposes, the NOL's were

carried back and utilized in years in which the federal tax rate was 46 percent (The h NOL was carried back to o.)

In order to be consistent with generally accepted accounting principles, as set forth in APB Opinion No. 11, Taxpayer calculated the provision for deferred income taxes on book-tax timing differences, including those subject to section 167(1) normalization rules, in amounts that would result in the total provision for income tax expense<sup>3</sup> (current and deferred) at a statutory income tax rate for the particular year being addressed. In order to provide total tax expense for federal income tax purposes at the statutory rates of 39.95 percent and 34 percent, respectively, for h and n, recognizing a current tax benefit at 46 percent due to the NOL carryback, the resulting deferred income taxes on all book-tax timing differences were provided at a rate that was higher than the current statutory rate. That is, the tax rate differential, as a result of the NOL carryback, has been allocated pro rata to all timing items for the loss year.

Section 203(e) of the Act provides that the "excess tax reserve" as that term is defined in section 203(e)(2)(A) should be reduced no more rapidly or to a greater extent than under the average rate assumption method.

The methodology employed in calculating the amount of deferred income taxes satisfies the normalization requirements in section 1.167(1)-1(h)(1)(iii) of the regulations in so far as it provided deferred income taxes resulting from the use of different methods of depreciation for its actual income tax liability and for regulatory purposes. The fact that it used a tax rate which allowed it to reflect the total provision for income tax expense at the current year's statutory rate is appropriate, is consistent with the normalization requirements, and is consistent with generally accepted accounting principles.

Therefore, based on your representations and our legal analysis, we rule with respect to Plan that:

1. The cost of service treatment, for Station ITC, of the ratable amortization of ITC credited to Account 186 for the period a through b, and the increase in rate base for the Account 186 balance and the subsequent amortization over c years of the Account 186 balance at b, is in compliance with the normalization requirements for ITC under section 46(f)(2) of the Code.
2. The cost of service treatment of Station deferred federal income taxes due to accelerated depreciation charged to Account 186 for the period a through b, and the increase in rate base for the balance in Account 186 and the subsequent amortization over c years of the deferral account balance at b, is in compliance with the normalization requirements for accelerated depreciation under section 168(e)(3) of the 1954 Code.
3. The calculation of the revenue requirements for the test year and the phase-in plan years, using the reduction in rate base for the balances of accumulated depreciation and deferred income taxes, as calculated in accordance with section 1.167(1)-1(h)(6) of the regulations, and the deferral of a portion of the return and the subsequent recovery of that deferral by the end of Plan period is in compliance with normalization requirements of section 168(e)(3) of the 1954 Code.
4. The methodology used in calculating normalized depreciation when a net operating loss (the "NOL") is carried back to years in which the federal income tax rates were higher than in the year of the NOL, to the items that gave rise to deferred taxes including normalized depreciation in the year of the NOL and the subsequent flowback of the deferred taxes related to such normalized depreciation is in compliance with the requirements of section 203(e) of the Act and section 1.167(1)-1(h)(iii) of the regulations for cost of service purposes.

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 used 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 17.04 of Rev. Proc. 88-1, 1988-1 I.R.B. 7, 19. However, when the criteria in section 17.05 of Rev. Proc. 88-1 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 transactions covered by this ruling are consummated.

Assistant Chief Counsel  
(Passthroughs & Special

Industries)

By  
Charles B. Ramsey  
Chief, Branch 6

<sup>1</sup> Mirror CWIP is a ratemaking procedure in which increasing amounts of construction work in progress are included in rate base before a plant goes into service, providing the utility with a current rate of return on a portion of its investment during the construction period. Once the plant is placed in service, an amount equal to that return is capitalized to the cost of the plant and a customer liability account is created.

<sup>2</sup> Expenses related to Station referred to here are book depreciation, decommissioning expense, real estate taxes, current state and federal income taxes, deferred state and federal income taxes and amortization of ITC and are charged or credited as appropriate.

<sup>3</sup> Total tax expense refers to the provision only, not the flow back of prior year's deferred taxes, subject to section 203(e) of the Act normalization rules, which are being reversed at the weighted average rates at which they were provided.

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Tax and Accounting  
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Source: IRS Documents > PLRs/TAMs and Other Advice > 1993 > PLR 9336010

**PLR 9336010**

**Section 168 -- ACRS Depreciation**

**UIL Number(s) 0168.24-01**

**Date: June 7, 1993**

**Refer Reply to: CC:DOM:P&SI:Br6 - TR-31-1090-92**

**In re: Private Letter Ruling Request on  
Normalization of Excess Tax Reserve**

**LEGEND:**

**Taxpayer = \* \* \***

**Commission A = \* \* \***

**Commission B = \* \* \***

**Staff = \* \* \***

**State X = \* \* \***

**Docket Y = \* \* \***

**a = \* \* \***

**b = \* \* \***

**c dollars = \* \* \***

**d dollars = \* \* \***

**e dollars = \* \* \***

**f dollars = \* \* \***

Dear \* \* \*

This letter responds to your letter of June 8, 1992, requesting a ruling under the normalization requirements of sections 167(l) and 168 of the Internal Revenue Code with respect to the excess tax reserve resulting from a net operating loss ("NOL") carryback.

Taxpayer represents that the facts are as follows:

Taxpayer is a public utility engaged in the generation and distribution of electricity in State X. Taxpayer is regulated by Commissions A, B, and the Federal Energy Regulatory Commission, and files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

For the tax year of a, Taxpayer reported on its amended federal income tax return an ordinary loss of c dollars. Of this amount, an ordinary loss of d dollars is attributed to Taxpayer's regulated electric operations. The reconciliation of book income and ordinary tax loss in a for regulated electric operations is as follows:

Pretax Income (Loss)

Book and tax differences:

Accelerated depreciation

Rate moderation plan deferrals

Other

### Ordinary loss

The ordinary loss of d dollars in a from regulated electric operations was carried back to b to offset e dollars of ordinary income from regulated electric operations.

On its financial statements for a, Taxpayer recorded the deferred taxes for all timing differences originating in a at a 34 percent rate, which is the statutory tax rate for a. As a result, Taxpayer's financial statements for a did not report any excess deferred taxes resulting from the NOL carryback to b when the statutory tax rate was 46 percent.

For ratemaking purposes, however, the Staff, in Docket Y, recommended that Taxpayer's deferred taxes be increased by the excess deferred taxes of f dollars resulting from the carryback of the NOL in a to offset the ordinary income from regulated electric operations in b. This adjustment is calculated by multiplying the b ordinary income of e dollars by the tax-rate differential of 12 percent. The effect of the Staff's adjustment is to reduce Taxpayer's rate base.

In its order in Docket Y, Commission A adopted the Staff's recommendation. However, Commission A did not determine the amortization method and period related to the excess tax reserve of f dollars. Instead, in the Order on Rehearing for Docket Y, Commission A ordered Taxpayer to request and obtain a letter ruling from the Internal Revenue Service on the appropriate manner in which to amortize the excess tax reserve. Accordingly, Taxpayer seeks the following ruling:

Whether section 203(e) of Tax Reform Act of 1986 (the "Act"), 1986-3 (Vol. 1) C.B. 63, applies to the excess deferred taxes created in a as a result of the carryback of the a tax loss to b when these excess deferred taxes are not related to the use of accelerated depreciation?

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 167(l) of the Code generally provides that public utilities are entitled to use accelerated methods of depreciation if they use a "normalization method of accounting." A normalization method of accounting is defined in section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A).

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

Section 1.167(l)-1(h)(1)(iii) of the regulations provides that the amount of Federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a depreciation method for tax purposes results in a net operating loss carryover (as determined under section 172 of the Code) to a year succeeding such taxable year that would not have arisen (or an increase in such carryover that would not have arisen) had the taxpayer determined the reasonable allowance under section 167(a) using the depreciation method for ratemaking 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.

For tax years beginning on or after July 1, 1987, section 601 of the Act, 1986-3 (Vol. 1) C.B. 166, reduces the federal income tax rate on corporate taxable income from 46 percent to 34 percent. Section 203(e) of the Act provides rules for reducing the excess tax reserve resulting both from that rate reduction and from the smaller reduction in rates for tax years beginning before and ending after July 1, 1987.

According to section 203(e)(1) of the Act, 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 Code 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 this reserve would be reduced under the average rate assumption method ("ARAM").

The term "excess tax reserve" is defined in section 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former section 167(l)(3)(G)(ii) or 168(e)(3)(B)(ii) of the Code as in effect on the day before the date of the enactment of the Act, over

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in the taxpayer's regulated books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of section 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that section 203(e) of the Act does not modify the normalization requirements of section 167(l) or section 168(j) of the Code.

In addition, Rev. Proc. 88-12 provides that in lieu of using the ARAM, certain taxpayers may use the Reverse South Georgia Method ("RSGM") to amortize the excess tax reserve. If the RSGM is used, section 5.01 of Rev. Proc. 88-12 provides that the taxpayer is deemed to satisfy the normalization requirements of section 203(e) of the Act.

Taxpayer's ruling request relates to the excess tax reserve resulting from the carryback of the NOL in a to b. The Federal corporate income tax rates in a and b were 34 percent and 46 percent, respectively. For ratemaking purposes, the deferred income taxes on all timing differences originating in a that were used to offset the ordinary income from regulated electric operations in b were provided at the tax rate of 46 percent. When these timing differences reverse, the taxable income attributable to these reversals is taxed at a 34 percent rate (assuming no increase in corporate income tax rates). As a result, in Docket Y, Taxpayer's rate base was reduced to reflect the excess tax reserve resulting from the interaction of the reduction in corporate income tax rates and the NOL carryback.

For a public utility to use accelerated depreciation in determining its Federal income tax liability, section 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under section 203(e) of the Act, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly than this reserve would be reduced under the ARAM. Thus, section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates.

By its own terms, section 203(e) of the Act applies only to timing differences that are subject to the normalization provisions of sections 167 and 168 of the Code. These provisions require that deferred taxes attributable to accelerated depreciation must be normalized. Thus, if the excess tax reserve in



question is attributable to accelerated depreciation, the limitations of section 203(e) of the Act would apply for ratemaking purposes; however, if this excess tax reserve is not attributable to accelerated depreciation, the ratemaking treatment of the excess tax reserve is outside the scope of section 203(e) of the Act.

The issue in Taxpayer's ruling request is whether all, or a portion, of the excess tax reserve resulting from the NOL carryback is attributable to the timing difference for accelerated depreciation. Taxpayer and the Staff have concluded that the excess tax reserve is allocable to any timing difference other than accelerated depreciation. In support of this conclusion, Taxpayer and the Staff have made two arguments.

First, during the rate case for Docket Y, the Staff argued that the timing differences related to the rate moderation plan ("RMP") deferrals caused the NOL in a and thus, the excess tax reserve should be allocated entirely to the RMP deferrals. This position, however, is not supported by the facts in this case. In a, the timing difference for the RMP deferrals reduced book income but this timing difference is less than the book income. As a result, if the timing difference for the RMP deferrals was the only difference between book and tax income in a, there would have been no NOL in a. Thus, in a, the timing difference for the RMP deferrals did not cause the NOL in and of itself.

Second, Taxpayer argues that by applying a "with and without" methodology when a NOL carryover exists, section 1.167(l)-1(h)(1)(iii) of the regulations prescribes a method for identifying the extent to which accelerated depreciation contributes to a NOL. And, therefore, with or without accelerated depreciation, Taxpayer's ordinary loss from regulated electric operations in a is sufficiently large to offset the entire amount of ordinary income from regulated electric operations in b and consequently, the excess tax reserve resulting from the carryback of the a NOL to b is not attributable to accelerated depreciation.

Taxpayer's position, however, misunderstands the purpose of section 1.167(l)-1(h)(1)(iii) of the regulations. It does not allocate a NOL among the timing differences originating in the loss year. Instead, section 1.167(l)-1(h)(1)(iii) determines the amount and time of the deferral of taxes when a taxpayer uses accelerated depreciation.

Under section 1.167(l)-1(h)(1)(iii) of the regulations, the amount of the deferral is generally computed by using the tax rates in effect in the tax year in which accelerated depreciation is used and the deferral generally is recorded in such tax year. However, if using accelerated depreciation results in a NOL carryover, which tax rates to use and when to make the deferral are left to the discretion of the Service. This is necessary because in that case, the taxpayer does not realize the actual tax benefits of using accelerated depreciation in the loss year and the realization of such benefits depends upon future taxable income. Consequently, the "with and without" method applicable to NOL carryovers in section 1.167(l)-1(h)(1)(iii) does not eliminate the normalization requirement of recording deferred taxes when accelerated depreciation results in a NOL carryover; instead, it gives the Service the discretion to allow the amount and time of the deferral to be determined in a tax year other than the loss year. Accordingly, the "with and without" method applicable to a NOL carryover does not allocate the NOL among the timing differences originating in the loss year.

In this case, Taxpayer has not shown which particular items caused the NOL in a. If no particular items caused the NOL, then an appropriate methodology would be pro rata allocation of the excess tax reserve, as a result of the NOL carryback, to all timing differences for the loss year. This methodology satisfies the normalization requirements of section 1.167(l)-1(h)(1)(iii) of the regulations because the method provides for deferred taxes at the statutory tax rate at which Taxpayer realized the actual tax benefits of using accelerated depreciation. We note that pro rata allocation is consistent with generally accepted accounting principles as set forth in APB Opinion No. 11, Accounting for Income Taxes.

As determined under this ruling, a portion of the excess tax reserve resulting from the NOL carryback will be allocated to the timing difference for accelerated depreciation. Accordingly, this portion is subject to the normalization requirements of section 203(e) of the Act. To the extent that the excess tax reserve is attributable to timing differences other than accelerated depreciation, section 203(e) of the Act does not apply to such excess tax reserve for ratemaking purposes.

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

1. The excess tax reserve resulting from the NOL carryback should be allocated pro rata to all timing differences originating in the loss year.
2. For ratemaking purposes, section 203(e) of the Act applies to the portion of the excess tax reserve

allocated to the timing difference for accelerated depreciation. As to the portion of the excess tax reserve allocated to timing differences other than accelerated depreciation, the ratemaking treatment of such reserve is outside the scope of section 203(e) of the Act.

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

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

Sincerely yours,

CHARLES B. RAMSEY  
Chief, Branch 6  
Office of Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2):  
copy of this letter  
copy for section 6110 purposes.

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