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LEGEND:

Taxpayer =

Subsidiary =
State =
Commission =
Date =
Docket =
Year =
Director =

Dear :

This letter responds to the request, dated November 27, 2007, of Taxpayer for a ruling on whether it is a violation of the normalization provisions of the Internal Revenue Code (the Code) to reduce the amount of Subsidiary's federal tax expense by a deduction under § 199 when such deduction is not available to the Subsidiary due to a net operating loss carryover.

The representations set out in your letter follow.

Taxpayer is the parent company of Subsidiary, an investor-owned regulated public utility headquartered in State. Taxpayer's business includes generation, transmission, and distribution of electrical energy within State. Subsidiary's regulated utility operations are subject to the regulatory jurisdiction of Commission with regard to its retail rates and certain conditions of service.

On Date, Subsidiary filed an application for an increase to its service rates with Commission. That request was captioned as Docket. Commission used a test year to determine the revenue requirements of Subsidiary. For the test year, Subsidiary had no federal income tax liability due to a net operating loss carryover (NOL). The rules of Commission do not permit Commission to take an NOL into account in determining the federal tax expense component of a regulated entity's revenue requirements. Thus, in determining Subsidiary's revenue requirements, Commission calculated Subsidiary's federal tax expense component using "pro-forma" federal tax liability. An element of this pro-forma calculation was a domestic production activities deduction (DPAD) under § 199. Use of the § 199 DPAD reduces the amount that Subsidiary is permitted to recover as federal tax expense from ratepayers and thus reduces rates below the level they would be absent the use of the DPAD. Taxpayer and Subsidiary have requested that the Service rule that the required use of the § 199 DPAD, unavailable to Subsidiary due to the presence of an NOL, to calculate Subsidiary's revenue requirements (and thus its rates) constitutes a violation of the normalization provisions of the Code.

LAW AND ANALYSIS

In general, normalization is a system of accounting used by regulated public utilities to reconcile the tax treatment of accelerated depreciation of public utility assets with the regulatory treatment of depreciation of assets, which allows the utility to recover the cost over the actual useful life of the asset. Under normalization, a utility gets the tax benefit of the Investment Tax Credit (ITC) or accelerated depreciation in the early years and flows that benefit out to ratepayers ratably over the regulatory useful life of the asset in the form of reduced rates.

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

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

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

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A).

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

Section 199 provides, in general, a deduction of up to 9 percent of a taxpayer’s qualified production activity income (QPAI). QPAI is the excess of a taxpayer’s domestic production gross receipts over the expenses allocable to those receipts, including depreciation. Section 199(c)(4)(A)(i)(III) provides that receipts from the sale of electricity and natural gas are included within domestic production gross receipts.

In 2005, the Federal Energy Regulatory Commission (FERC) issued an order entitled “Guidance Order on Tax Deduction for Manufacturing Activities Under American Jobs Creation Act of 2004.” In that order, FERC states that section 199 “will have ratemaking implications only for public utilities that make jurisdictional sales of electricity at stated cost-based rates and cost-based formula rates. Income taxes are a cost that is included in virtually all cost-based rates. Accordingly, we expect these public utilities to appropriately reflect the [199] amounts in future filings to change their cost-based stated rates and cost-based formula rates.”

Section 1.167(1)-1(a)(1) describes the reach of normalization requirements for public utility property as pertaining only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. While the § 199 deduction is calculated in part by reference to depreciation that is possibly greater than regulatory straight-line depreciation, that deduction is not accelerated in early years like depreciation; there is no reserve for tax that is created by the utility paying lower taxes using the §199 deduction in early years of an asset's life and "paying back" that tax reserve to ratepayers over the later years of the assets' life. In short, the § 199 deduction neither fits into the parameters of normalization under the Code and regulations nor causes the same type of variance between tax accounting and regulatory accounting as depreciation. The limited reach of normalization extends only to depreciation and its definite predictable effects.[1]

Thus, we conclude that it is not a violation of the normalization provisions of the Code to require the use of the § 199 DPAD, unavailable to Subsidiary due to the presence of an NOL, to calculate Subsidiary's revenue requirements (and thus its rates) as described above.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the transaction described above. Further, we do not conclude herein that use of pro forma federal tax liability in calculating revenue requirements in utility ratemaking is never violative of the normalization provisions of the Code; we conclude only that the use of the § 199 DPAD as described above does not violate those provisions.

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

[1] Historically, normalization was intended to ensure that, with respect to utilities, accelerated depreciation had the effect intended by Congress, to stimulate the economy by providing incentives for business to invest in assets. If public service commissions were permitted to order utilities to pass the benefits of accelerated depreciation immediately to ratepayers, the utility would have no capital to invest in needed equipment, basically transforming a business tax benefit into an individual consumer tax benefit. In this case, the historical concerns that led Congress to require normalization are not present. The § 199 deduction does take depreciation, including accelerated depreciation, into account but the calculation of the deduction results in the opposite of the usual normalization issue. The § 199 deduction is calculated as a percentage of the income from an activity less the deductions allocable to that activity. To the extent that accelerated depreciation is taken into account in a particular year such accelerated depreciation would reduce the amount of the § 199 deduction, thus increasing the amount of tax to be paid by the utility and collected from ratepayers.

authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

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

cc: