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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-104385-01

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Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Assets Cease to be Public Utility Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, notice of public hearing, and withdrawal of previous proposed regulations.

SUMMARY: This document contains proposed regulations that provide guidance on the normalization requirements applicable to public utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law. The proposed regulations permit a utility whose assets cease to be public utility property to return to its ratepayers the normalization reserve for excess deferred income taxes (EDFIT) with respect to those assets and, in certain circumstances, also permit the return of part or all of the reserve for accumulated deferred investment tax credits (ADITC) with respect to those assets. This document also provides notice of a public hearing on these proposed regulations and a withdrawal of proposed regulations [REG-104385-01] published March 4, 2003, at 68 FR 10190.

DATES: Written or electronic comments must be received by March 21, 2005. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for April 5, 2006, at 10 a.m. must be received by March 15, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-104385-01), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-104385-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-104385-01). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Selig, at (202) 622-3040; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard Hurst, at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of

1986, Public Law 99-514 (100 Stat. 2146), and former section 46(f) of the Code.

Proposed regulations relating to the normalization requirements applicable to electric utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law [REG-104385-01] were published in the **Federal Register** on March 4, 2003 (the 2003 proposed regulations). The 2003 proposed regulations would have provided rules under which electric utilities whose electricity generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, could continue to flow through certain reserves associated with those assets without violating the normalization requirements. In response to public comments and after further analysis, the 2003 proposed regulations are withdrawn, and new regulations are proposed in this document.

#### Normalization Method of Accounting

Section 168 of the Code permits the use of accelerated depreciation methods. Section 168(f)(2) provides, however, that accelerated depreciation is permitted with respect to public utility property only if the taxpayer uses a normalization method of accounting for ratemaking purposes.

Under a normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater than actual tax expense. The difference between the ratemaking tax expense and the actual tax expense is added to a reserve (the accumulated deferred

federal income tax reserve, or ADFIT). The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the accelerated method used in computing actual tax expense.

This accounting treatment prevents the immediate flow-through to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus is available to utilities as investment capital. When the accelerated method provides lower depreciation deductions in later years, only the ratemaking tax expense is collected from ratepayers and the difference between actual tax expense and ratemaking tax expense is charged to ADFIT.

#### Excess Deferred Income Tax

The Tax Reform Act of 1986 (the 1986 Act) reduced the highest corporate tax rate from 46 percent to 34 percent. The excess deferred federal income tax (EDFIT) reserve is the balance of the deferred tax reserve immediately before the rate reduction over the balance that would have been held in the reserve if the 34 percent rate had been in effect for prior periods. The EDFIT reserves were amounts that utilities had collected from ratepayers to pay future taxes that, as a result of the 1986 Act reduction in corporate tax rates, would not be imposed.

Section 203(e) of the 1986 Act specifies the manner in which the EDFIT reserve must be flowed through to ratepayers under a normalization method of accounting. It

provides that the EDFIT reserve may be reduced, with a corresponding reduction in the cost of service the utility collects from ratepayers, no more rapidly than the EDFIT reserve would be reduced under the average rate assumption method (ARAM). For taxpayers that did not have adequate data to apply the average rate assumption method, subsequent guidance permitted use of the reverse South Georgia method as an alternative. In general, both the average rate assumption method and the reverse South Georgia method spread the flow-through of the EDFIT reserve over the remaining lives of the property that gave rise to the excess.

#### Accumulated Deferred Investment Tax Credits (ADITC)

Former section 46 of the Code similarly addressed the flow-through to ratepayers of the investment tax credit determined under that section. Under former section 46(f)(1), the rate base (the amount on which the utility is permitted to collect a return from ratepayers) could be reduced by reason of the credit if the reduction in the rate base was restored not less rapidly than ratably. If the rate base is reduced, the credit may not also be used to reduce the utility's cost of service. Under former section 46(f)(2), an electing utility could flow through the investment credit not more rapidly than ratably (that is, could reduce the cost of service collected from ratepayers by no more than a ratable portion of the credit) over the investment's regulatory life. The balance of the credit remaining to be flowed through to ratepayers would be held in a reserve for accumulated deferred investment tax credits (ADITC). If the utility elected ratable flow-through of the credit, the rate base could not be reduced by reason of any portion of the credit.

### Private Letter Rulings

The IRS has issued a number of private letter rulings holding that flow-through of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flow-through is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flow-through is permitted. After further consideration, the IRS and Treasury have concluded that former section 46(f) does not, in all cases, prohibit flowthrough of ADITC reserves after deregulation and that section 203(e) of the Tax Reform Act does not preclude flowthrough of the EDFIT reserve with respect to deregulated property.

### **Explanation of Provisions**

The 2003 proposed regulations provided that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise (deregulated public utility property), may continue to flow through EDFIT reserves associated with those assets without violating the normalization requirements. The rate of flowthrough was limited to the rate that would have been permitted under a normalization method of accounting if the assets had remained public utility property. But for section 203(e) of the 1986 Act, the entire EDFIT reserve would have been flowed through to ratepayers when the reduction in rates became effective, whether the assets to which the EDFIT reserve was attributable remained public utility property for their entire useful life or

were subsequently deregulated or sold. As noted in the preamble of the 2003 proposed regulations, the IRS and Treasury have concluded that section 203 of the 1986 Act provides a schedule for flowing through the EDFIT reserve but that nothing in that section suggests that something less than the entire reserve should ultimately be flowed through to ratepayers. Accordingly, these proposed regulations retain the rule of the 2003 proposed regulations, with the effective date changes described below, for generation assets and extend the application of the rule to all other public utility property.

The 2003 proposed regulations also provided similar rules under which utilities could continue to flow through ADITC reserves associated with deregulated generation assets without violating the normalization requirements. The proposed regulations did not address the treatment of deregulated assets under former section 46(f)(1) (relating to the use of the investment credit to reduce the taxpayer's rate base). After further consideration, the IRS and Treasury have concluded that flowthrough of the ADITC reserve should not continue after deregulation except to the extent the utility is permitted to recover stranded costs after deregulation.

If an asset qualifying for the investment tax credit is purchased by a utility, the allowance of the credit, without flowthrough, lowers the utility's actual tax expense but does not result in higher tax expense for ratepayers than would have been the case if the asset had not been purchased. Thus, in the absence of flowthrough, the investment tax credit is a subsidy from the Federal government for the purchase of the asset rather than a transfer from ratepayers to the utility. The underlying policy of former section 46(f) is to share this

subsidy between ratepayers and utilities in proportion to their respective contributions to the purchase price. In general, former section 46(f) treats ratepayers as contributing to the purchase price when ratemaking depreciation expense with respect to the asset is included in the rates they pay, resulting in full flowthrough over the asset's regulatory life. In the case of a deregulated asset, the contribution of ratepayers can be appropriately measured by the ratemaking depreciation expense they are charged with respect to the asset and any additional stranded cost that the utility is permitted to recover with respect to the asset after its deregulation.

Accordingly, the proposed regulations permit flowthrough of the ADITC reserve with respect to public utility property to continue after its deregulation only to the extent the reduction in cost of service does not exceed, as a percentage of the ADITC with respect to the property at the time of deregulation, the percentage of the total stranded cost that the taxpayer is permitted to recover with respect to the property. In addition, the credit may not be flowed through more rapidly than the rate at which the taxpayer is permitted to recover the stranded cost with respect to the property.

As in the case of the EDFIT reserve, these proposed regulations extend the flowthrough rule for generation assets to all public utility property. In addition, these proposed regulations provide equivalent rules for property to which former section 46(f)(1) (relating to rate base restoration) applies.

### **Proposed Effective Date**



The 2003 proposed regulations would have applied to public utility property deregulated after March 4, 2003. Utilities would have been permitted an election to apply the proposed rules to property that was deregulated on or before that date.

Comments suggested that deregulation agreements between utilities and their regulators entered into before the March 4, 2003 proposed effective date were based on the only guidance then available (i.e., the private letter rulings issued by the IRS) and that the availability of a retroactive election could effectively change the terms of those agreements. Although private letter rulings are directed only to the taxpayers who requested them and may not be used or cited as precedent, the IRS and Treasury have concluded that the Secretary's authority under section 7805(b)(7) to provide for retroactive elections should not be exercised in a manner that impairs existing agreements between utilities and their regulators. Accordingly, these proposed regulations do not include a similar election to apply the regulations retroactively.

As noted above, these proposed regulations are broader in scope than the 2003 proposed regulations. Accordingly, these regulations are proposed to apply to public utility property that becomes deregulated public utility property after December 21, 2005. For public utility property that becomes deregulated public utility property on or before December 21, 2005, the IRS will follow the holdings set forth in the private letter rulings that prohibit flow-through of the EDFIT and ADITC reserves associated with an asset after the asset's disposition. Flowthrough will be permitted, however, if it is consistent with the 2003 proposed regulations, and occurs during the period March 5, 2003, through the earlier of

the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or December 21, 2007.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted (in the manner described in the ADDRESSES caption) timely to the IRS. All comments will be available for public inspection and copying. Treasury and IRS specifically request comments on the clarity of the proposed regulations and how they may be made clearer and easier to understand.

A public hearing has been scheduled for April 5, 2006, at 10 a.m. in room 7218 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 15, 2006.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal author of these regulations is David Selig, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Withdrawal of Proposed Regulations**

Under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-104385-01) published in the **Federal Register** on March 4, 2003 (68 FR 10190) is withdrawn.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.46-6 is amended by adding paragraph (k) to read as follows:

' 1.46-6 Limitation in case of certain regulated companies.

\* \* \* \* \*

(k) Treatment of accumulated deferred investment tax credits upon the deregulation of public utility property--(1) Scope. This paragraph (k) provides rules for the application of former sections 46(f)(1) and 46(f)(2) of the Internal Revenue Code with respect to public utility property that ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated public utility property).

(2) Ratable amount--(i) Restoration of rate base reduction. A reduction in the taxpayer's rate base on account of the credit with respect to public utility property that becomes deregulated public utility property is restored ratably during the period after the property becomes deregulated public utility property if the amount of the reduction remaining to be restored does not, at any time during the period, exceed the restoration

percentage of the recoverable stranded cost of the property at such time. For this purpose--

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated;

(B) The recoverable stranded cost of the property at any time is the stranded cost of the property that the taxpayer will be permitted to recover through rates after such time; and

(C) The restoration percentage for the property is determined by dividing the reduction in rate base remaining to be restored with respect to the property immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(ii) Cost of service reduction. Reductions in the taxpayer's cost of service on account of the credit with respect to public utility property that becomes deregulated public utility property are ratable during the period after the property becomes deregulated public utility property if the cumulative amount of the reduction during such period does not, at any time during the period, exceed the flow-through percentage of the cumulative stranded cost recovery for the property at such time. For this purpose--

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated;

(B) The cumulative stranded cost recovery for the property at any time is the stranded cost of the property that the taxpayer has been permitted to recover through rates on or before such time; and

(C) The flow-through percentage for the property is determined by dividing the amount of credit with respect to the property remaining to be used to reduce cost of service immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(3) Cross reference. See ' 1.168(i)-(3) for rules relating to the treatment of balances of excess deferred income taxes when public utility property becomes deregulated public utility property.

(4) Effective dates--(i) In general. This paragraph (k) applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(ii) Application of regulation project REG-104385-01 to pre-effective date reductions in cost of service. A reduction in the taxpayer's cost of service will be treated as ratable if it is consistent with the proposed rules in regulation project REG-104385-01 (2003-1 C.B. 634) and occurs during the period March 5, 2003, through the earlier of the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or December 21, 2007.

Par. 3. Section 1.168(i)-3 is added to read as follows:

' 1.168(i)-(3) Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

(a) Scope. This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146) with respect to public utility property (within the meaning of section 168(i)(10)) that ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated public utility property).

(b) Amount of reduction. If public utility property of a taxpayer becomes deregulated public utility property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) Cross reference. See ' 1.46-6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated public utility property.

(d) Effective dates--(1) In general. This section applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(2) Application of regulation project REG-104385-01 to pre-effective date reductions of excess deferred income tax reserve. A reduction in the taxpayer's excess deferred income tax reserve will be treated as ratable if it is consistent with the proposed rules in regulation project REG-104385-01 (2003-1 C.B. 634) and occurs during the period March 5, 2003, through the earlier of the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or December 21, 2007.

Deputy Commissioner for Services and Enforcement.