

[4830-01-p]

Published March 4, 2003

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-104385-01]

RIN 1545-AY75

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the normalization requirements applicable to electric utilities that benefit (or have benefitted) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law. The proposed regulations permit a utility whose electricity generation assets cease to be public utility property to return to their ratepayers the normalization reserves for excess deferred income taxes (EDFIT) and accumulated deferred investment tax credits (ADITC) with respect to those assets. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by, June 2, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 25, 2003, at 10 a.m. must be received by, June 2, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-104385-01), room 5226, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG-104385-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the 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, Treena Garrett, at (202) 622-7190 (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. The proposed regulations respond to changes in the electric power industry resulting from deregulation of electricity generation facilities.

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 flowthrough 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 cost-free 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, depleting the utility's stock of cost-free capital.

Excess Deferred Income Tax

The Tax Reform Act of 1986 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 reduction in corporate tax rates, would not have to be paid.

Section 203(e) of the Tax Reform Act of 1986 specifies the manner in which the EDFIT reserve can 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 flowthrough 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 limited the ability of ratepayers to benefit from the investment tax credit determined under that section. Under former section 46(f)(2), an electing utility could flow through the investment credit ratably (that is, could reduce the cost of service collected from ratepayers by 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 flowthrough of the credit, the rate base (the amount on which the utility is permitted to collect a return from ratepayers) could not be reduced by reason of any portion of the credit.

Deregulation of Generation Assets

When the normalization provisions were added to the Internal Revenue Code, electric utilities were vertically integrated to include generation, transmission, and distribution functions. Accelerated depreciation, investment credits, and normalization enhanced the cash flow needed to acquire and construct new generation assets. Driven by changes in technology and economics, however, the electric industry has been undergoing substantial changes. Many utilities have been selling generation assets to new entities that are not subject to rate of return regulation and are becoming transmission and distribution (or distribution-only) companies. In many cases, the deregulation of generation assets is occurring before the EDFIT and ADITC reserves associated with those assets have been flowed through to ratepayers.

The Service has issued a number of private letter rulings holding that flowthrough 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 flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted.

After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.

The proposed regulations provide that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, may continue to flow through EDFIT and ADITC reserves associated with those assets without violating the normalization rules. The rate of flowthrough is limited, however, to the rate that would have been permitted if the assets had remained public utility property and the taxpayer had continued to use a normalization method of accounting (or ratable flowthrough of the credit) with respect to the assets. This result does not impose on utilities any burden unanticipated prior to deregulation and provides the flow-through originally anticipated by ratepayers, utility commissions, and utilities.

Comments Requested

In addition to comments relating to this notice of proposed rulemaking, comments are requested on the proper disposition of tax reserves (ADFIT, EDFIT, and ADITC) under the following set of facts. Regulated transmission assets from several public utilities (related or otherwise) are transferred to a utility partnership. This partnership is created solely as a transmission company. The transaction is subject to section 721 of the Code. The transmission assets are public utility property before the transfer and will be public utility property after the transfer. Is there a normalization violation if the deferred tax reserves are transferred to the new transmission company's regulated books and are considered in setting rates for the new transmission company? Alternatively, is there a normalization violation if the deferred tax reserves remain on the transferors' regulated books and are considered in setting their rates?

In addition, the proposed regulations do not address the treatment of deregulated assets under former section 46(f)(1) (relating to the use of the investment credit to reduce the rate base of electing taxpayers). Comments are also requested on this issue.

Proposed Effective Date

The regulations are proposed to apply to property that becomes deregulated generation property after ,March 4, 2003 . In addition, a utility may elect to apply the proposed rules to property that becomes deregulated generation property on or before, March 4, 2003 . The election is made by attaching a written statement to the utility's return for the tax year in which the proposed rules are published as final regulations.

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 June 25, 2003, at 10 a.m. in 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.

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 by, June 2, 2003.

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.

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 regulated generation assets--(1) Scope. This paragraph (k) provides rules for the application of former section 46(f)(2) of the Internal Revenue Code with respect to public utility property that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(2) Amount of reduction. If public utility property of a taxpayer becomes deregulated generation property to which this section applies, the reduction in the taxpayer's cost of service permitted under former section 46(f)(2) is equal to the amount by which the cost of service could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued to reduce its cost of service by a ratable portion of the credit with respect to such property.

(3) Cross reference. See §1.168(i)-(3) for rules relating to the treatment of balances of excess deferred income taxes when utilities dispose of regulated generation assets.

(4) Effective date--(i) General rule. This paragraph (k) applies to property that becomes deregulated generation property after, March 4, 2003.

(ii) Election for retroactive application. A utility may elect to apply this paragraph (k) to property that becomes deregulated generation property on or before, March 4, 2003. The election is made by attaching the statement "ELECTION UNDER §1.46-6(k)" to the taxpayer's return for the tax year in which this paragraph (k) is published as a final regulation.

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 regulated generation assets.

(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 that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(b) Amount of reduction. If public utility property of a taxpayer becomes deregulated generation 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 generation assets.

(d) Effective date--(1) General rule. This section applies to property that becomes deregulated generation property after, March 4, 2003 .

(2) Election for retroactive application. A taxpayer may elect to apply this section to property that becomes deregulated generation property on or before, March 4, 2003. The election is made by attaching the statement "ELECTION UNDER §1.168(i)-3" to the taxpayer's return for the tax year in which this section is published as a final regulation.

David Mader

Assistant Deputy Commissioner of Internal Revenue.