

rate assumption method (“ARAM”). The relevant facts as represented in your submission are set forth below.

FACTS

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

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

Taxpayer is principally engaged in the business of supplying electricity in State A. Taxpayer is subject to regulation as to rates and conditions of service by Commission A as well as Commission B. Both of these regulators establish Taxpayer’s rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated businesses. Commission A and Commission B treat accumulated deferred federal income tax liabilities (“ADFIT”) and excess deferred federal income tax liabilities (“EDFIT”) as a reduction to rate base in setting the allowed return for the utilities that they regulate. Taxpayer has claimed accelerated depreciation on its public utility property to the full extent those deductions have been available. Taxpayer has normalized the federal income taxes deferred as a result of it claiming these deductions in accordance with the Normalization Rules.

Commission B has adopted the Uniform Systems of Accounts “USOAs” and all electric utilities under the jurisdiction of Commission A, including Taxpayer, follow the USOAs. The USOAs contain several definitions relevant to Taxpayer’s request. Specifically, the USOAs define cost of removal “COR” as:

... the cost of demolishing, dismantling, tearing down or otherwise removing electric plant, including the cost of transportation and handling incidental thereto.

“salvage value” as:

... the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale.

“net salvage value” as:

... the salvage of property retired less the cost of removal.

“service value” as:

... the difference between original cost and net salvage value of electric plant.

“service life” as:

... the time between the date electric plant is includible in electric plant in service, or electric plant leased to others, and the date of its retirement.

and “depreciation” as:

... the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance.

Therefore, for the purposes of regulatory reporting, the net positive value or net cost of disposing of an asset at the end of its life is incorporated into the annual depreciation charge. COR is, therefore, a component of establishing the applicable depreciation rate. Taxpayer breaks out the COR and salvage rates separately from depreciation. The net rate is considered the Life Rate that is approved by Commission A. The COR and salvage reserves are tracked separately from accumulated depreciation in Taxpayer’s continuing property records.

In order to fund its future COR, Taxpayers estimates the future COR and then spreads the estimated cost ratably over the life of the asset through adding the COR to the annual depreciation charge used by commission A to calculate the allowable rate for Taxpayer to charge its customers. If the COR is greater than the salvage value of the public utility property, then the Taxpayer’s property will in effect have a negative salvage value – which will create a negative depreciation rate (i.e. a depreciation rate that is greater than the value of asset). Alternately, if the net salvage value is positive it too will be reflected in Taxpayer’s depreciation rate. The depreciation rate will then be utilized by Commission A in computing the allowable rates for Taxpayer to charge its customers. In most cases the COR is negative, and therefore a component of establishing the annual depreciation charge. The COR reserve is reflected as an addition to Taxpayer’s accumulated depreciation account. When the COR is actually incurred, the amount expended is debited to that same account, thereby reducing the balance.

For tax purposes, COR is deductible only when actually incurred. Taxpayer, therefore, reports its customer collections that fund the COR reserve as taxable income over the operating life of an asset, claiming an offsetting tax deduction only at the end of the life of that asset when the asset is removed. Since COR is normalized in setting rates, customers are provided a tax benefit commensurate with their funding of COR. In other words, they are provided a COR tax benefit as they fund the COR reserve – prior to the time Taxpayer actually claims that benefit on its tax return.

The tax effect of COR funding as described creates a deferred tax asset (“DTA”). This represents the future benefit to be derived from the eventual COR tax deduction.

The COR-related DTA is included in Taxpayer's overall plant-related ADFIT account that reduces Taxpayer's ADFIT balance.

Prior to the Tax Cut and Jobs Act ("TCJA"), Taxpayer incorporated the COR into the annual depreciation charge without identifying the separate components of the depreciation and COR reserve charges. However, Taxpayer did maintain records that identified the separate components of non-COR and COR related depreciation that was reflected in the Taxpayers book depreciation balances. Consequently, Taxpayer distinguishes between COR book/tax differences and depreciation method/life differences even though they are both derived from Taxpayer's book depreciation rates and expense. Taxpayer's system can, therefore, track the reversals of these differences separately.

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

In anticipation of complying with the TCJA excess deferred tax Normalization Rules and the subsequent return of the TCJA Section 13001(d) excess tax reserve ("ETR") to customers, Taxpayer used its historical plant-related records in its regulatory books of account to separately compute both (1) its DTA related to COR and the associated excess tax deficit to be recovered from customers and (2) its DTL related to method/life differences and the associated ETR to be returned to customers, which included gross salvage value.

Taxpayer's Recent Commission A Proceeding

In Year A, Taxpayer filed an application with Commission A to set its rates for Period A. Upon the enactment of the TCJA in 2017, Taxpayer updated its filing with Commission A to reflect the impact of the lowered corporate tax rate. Among the impacts considered by Commission A was the proper computation of the ETR. Specifically, when computing the ARAM (as per TCJA Section 13001(d)(3)(B)), should the COR be included or not. Ultimately, Commission A and Taxpayer did not reach an agreement on the inclusion of COR into the ETR and the resulting disagreements relating to the COR-related EDFIT. In summary, Commission A's proposed method of

computing the return of ADFIT to customers under ARAM included the accrual for COR, resulting in a larger amount of book depreciation in all years (and an earlier return of ETR to customers) than under the computational method proposed by Taxpayer. Commission A, In Month A of Year B, stated that it intended that Taxpayer comply with the Normalization rules at all times, and permitted Taxpayer to request a private letter ruling from the Internal Revenue Service.

RULINGS REQUESTED

- 1) Whether, under the circumstances described above, Taxpayer's DTA for cumulative timing differences between (a) recognition of accrued gross COR with respect to public utility property as an increase in depreciation expense in its regulatory books of account and (b) the subsequent tax deduction of such costs upon disposition is subject to the normalization rules of Code Section 168(i)(9) and whether the associated excess deferred tax amount is subject to the normalization rules of TCJA Section 13001(d)?
- 2) Whether, under the circumstances described above, Taxpayer's DTL for the cumulative timing differences between (a) recognition of accrued gross salvage value with respect to public utility property as a reduction of depreciation expense in its regulatory books of account and (b) the subsequent taxation of such salvage amounts upon disposition is subject to the normalization rules of Code Section 168(i)(9) and whether the associated excess deferred tax amount is subject to the normalization rules of TCJA Section 13001(d) regardless of whether the gross salvage value timing differences are partially or fully offset by gross COR timing differences and whether the DTL related to gross salvage value differences is partially or fully offset by the DTA for gross COR differences?
- 3) Whether, under the circumstances described above, the computation of the reversal of the excess tax reserve for depreciation method and life differences for public utility property based on book depreciation amounts inclusive of an accrual of gross COR pursuant to the State Commission Method is consistent with the normalization requirements?
- 4) Whether, under the circumstances described above, computation of the reversal of the excess tax reserve for depreciation method and life differences for public utility property based on book depreciation amounts reflecting estimated gross salvage value but not an accrual of estimated gross COR pursuant to the Proposed Approach complies with or violates the normalization rules of TCJA Section 13001(d)?

LAW AND ANALYSIS

Section 168(f)(2) of the Internal Revenue Code, provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within

the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

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

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a “normalization method of accounting.” A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Treas. Reg. § 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertains only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 13001(a) of the TCJA reduced the corporate tax rate from 35 percent to 21 percent for taxable years beginning after December 31, 2017. TCJA Section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the ETR more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method (ARAM).

TCJA Section 13001(d)(3)(A) provides that “excess tax reserve” means the excess of reserve for deferred taxes (as described in § 168(i)(9)(A)(ii) as of the day before the corporate rate reductions provided in the amendments made by TCJA Section 13001(a) take effect, over the amount which would be the balance in such reserve, if the amount of such reserve were determined by assuming that the corporate tax rate reductions provided in the TCJA were in effect for all prior periods.

TCJA Section 13001(d)(3)(B) defines ARAM as the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such a method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying – 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 the amount of the timing differences which reverse during such period.

Rev. Proc. 2020-39, Section 4.01 provides that under Section 13001(d)(1) of the TCJA, taxpayers must use ARAM to calculate the reversal of their ETR, if the taxpayer's regulatory books are based upon the vintage account data necessary to use ARAM. However, if the taxpayer's regulatory books are not based upon the vintage account data that is necessary for the ARAM, use of the ARAM is not required. Rev. Proc. 2020-39, Section 4.02 provides that the determination of whether a taxpayer's regulatory books contain sufficient vintage account data necessary to use the ARAM is determined based on all the facts and circumstances. Rev. Proc. 2020-39, Section 5 states that the TCJA ETR normalization requirements are part of the overall pre-existing deferred tax Normalization Rules and that the revenue procedure is intended to be consistent with those rules.

For the COR-related amounts at issue in this request, the amounts are not protected by the Normalization Rules. Generally, § 168(i)(9)(A) does not refer to COR. Moreover, there is no acceleration of taxes for COR, but rather, a deferral. While COR may be a component of the calculation of the amount treated as book depreciation, it is a deduction under § 162 and has nothing to do with actual accelerated tax depreciation. While method and life differences closely related to depreciation are created and reversed solely through depreciation, such is not the case with COR. While the COR timing differences may often originate as a component of book depreciation, it reverses through the incurred COR expenditure.

Taxpayer's request 2 addresses the question of whether COR-related DTA (determined above to not be subject to the Normalization Rules) impacts the application of those rules to salvage value. While COR is not protected under the Normalization Rules, salvage value is specifically included – see § 168(i)(9)(A)(ii) – as a protected part of the normalized ETR. Neither the Internal Revenue Code nor the regulations require or direct that salvage value must be affected by or is necessarily related to the computation of COR, for purposes of the application of the Normalization Rules.

Because of their similarity, we address requests 3 and 4 together. The ETR created by the TCJA is the excess of the reserve for deferred taxes under § 168(i)(9)(A)(ii), as of the date before the corporate rate reductions under TCJA take effect, over the amount the reserve balance would be if the rate reductions had been in effect for all prior periods. The ETR is reduced over the remaining lives of the property

which gave rise to such reserve for deferred taxes based on the reversal of the underlying depreciation method and life differences subject to the normalization rules of Code Section 168(i)(9)(A)(ii). Thus, because COR is not subject to normalization, as concluded above, including the COR-related amounts in the excess taxes used to compute the ETR does not satisfy the requirements of TCJA Section 13001(d). Conversely, leaving the COR out of the ETR computation does satisfy the requirements of TCJA Section 13001(d).

Based on the forgoing we conclude that:

- 1) Taxpayer's DTA for cumulative timing differences between (a) recognition of accrued gross COR with respect to public utility property as an increase in depreciation expense in its regulatory books of account and (b) the subsequent tax deduction of such costs upon disposition is not subject to the normalization rules of Code Section 168(i)(9) and the associated excess deferred tax amount is not subject to the normalization rules of TCJA Section 13001(d).
- 2) Taxpayer's DTL for cumulative timing differences between (a) recognition of accrued gross salvage value with respect to public utility property as a reduction of depreciation expense in its regulatory books of account and (b) the subsequent taxation of such salvage amounts upon disposition is subject to the normalization rules of Code Section 168(i)(9) and the associated excess deferred tax amount is subject to the normalization rules of TCJA Section 13001(d) regardless of whether the gross salvage value timing differences are partially or fully offset by gross COR timing differences and whether the DTL related to gross salvage value differences is partially or fully offset by the DTA for gross COR differences.
- 3) The computation of the reversal of the excess tax reserve for depreciation method and life differences for public utility property based on book depreciation amounts inclusive of an accrual of gross COR pursuant to the State Commission Method is not consistent with the normalization rules of TCJA Section 13001(d).
- 4) The computation of the reversal of the excess tax reserve for depreciation method and life differences for public utility property based on book depreciation amounts reflecting estimated gross salvage value but not an accrual of estimated gross COR pursuant to the Proposed Approach complies with the normalization rules of TCJA Section 13001(d).

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

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

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

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

Sincerely,

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

cc: