Internal Revenue Service

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In Re: Request for rulings under the Consistency Rule of § 168(i)(9) of the Code and the Deferred-Tax-Account Computational Rules of Treas. Reg. § 1.167(l)-1(h)

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
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Refer Reply To:
CC:PSI:B06
PLR-104298-23

Date:
January 29, 2024

Legend:

Taxpayer =

Subsidiary =

a =
b =
c =
Resource =
State =
Commission A =
Consumer Advocate =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Application =
Standard Practices =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Decision A =
Decision B =

Dear :

This letter responds to a request for a private letter ruling dated March 1, 2023, submitted on behalf of Taxpayer and its wholly-owned Subsidiary, under § 168(i)(9) regarding the potential implementation of a proposed ratemaking adjustment under the depreciation normalization provisions of the Internal Revenue Code of 1986, as amended ("Code") and the regulations thereunder. This request is made pursuant to, and in compliance with, Rev. Proc, 2023-1.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is the common parent of an affiliated group of corporations filing a consolidated return on a calendar year basis. Taxpayer, as the common parent of the affiliated group, serves as the agent of Subsidiary for purposes of this private letter ruling request pursuant to § 1.1502-77(a) of the Regulations. Taxpayer and each of its subsidiaries are accrual-basis taxpayers.

Taxpayer, through its operating subsidiaries, serves more than a customers in b states. Subsidiary, a wholly-owned subsidiary of Taxpayer, is a regulated Resource public utility serving more than c customer connections located in State. As a member of the Taxpayer affiliated group, Subsidiary joins in the filing of a consolidated return with other Taxpayer operating companies. As is relevant to this private letter ruling request, Subsidiary is subject to the ratemaking jurisdiction of Commission A. Consumer Advocate, the independent consumer advocate at Commission A, participated in the rate proceeding culminating in the Date 1 settlement agreement ("Agreement") incorporated into the proposed rate order at issue in this private letter ruling request.

Subsidiary is subject to cost-of-service and rate-of-return ratemaking for its public utility property and thus is subject to the normalization requirements of § 168(i)(9) and the Treasury Regulations promulgated under that section and its predecessors. Its current General Rate Case ("GRC"), filed on Date 2, and denominated Application, employed three one-year test periods of Year 1, Year 2, and Year 3. In preparing the Application, Subsidiary initially calculated its rate base in accordance with applicable Commission A Standard Practices, which provide as follows:

All rate base items, including capital additions and depreciation, shall not be escalated but rather shall be subject to two test years and an attrition year, consistent with Decision A.

The specific ratemaking adjustment that is the subject of this ruling request pertains to the calculation of rate base for Year 3, the third year of rates, that is, the so-called attrition year referenced above, and the relationship of that calculation to the calculation of other normalization-related elements discussed below. Decision A, effective Date 3 (interim order adopting generic rate case plan ("RCP")), provides the

specifics for setting rates in the third year of a three-year rate cycle with respect to assumptions made for computing rate base, as well as the book depreciation and income-tax components of cost of service. These computational approaches of the interim order were adopted as final in Decision B, effective Date 4. Specifically, a footnote of Decision A states:

The attrition allowance methodology provides for rate base additions in year 3 by adding the difference between test year 1 and test year 2 rate base to test year 2 rate base. Depreciation expense is handled in the same way.

By averaging the beginning and ending amounts from year 1 and year 2 rate base, the mathematical result of assuming that the difference between year 2 and year 3 rate base is the same as the difference between year I and year 2 rate base is that year 1 activity serves as a proxy for year 3 activity notwithstanding the fact that it would only be fortuitous that it bears any relationship with actual or projected year 3 activity. It is true that, as the footnote, supra, indicates, depreciation expense for cost-of-service purposes is "handled in the same way," but that calculation is not, and cannot be, mathematically consistent with the rate base calculation and components thereof. As described in the ruling request, the results of the application of this method are that (i) depreciation expense is impermissibly decoupled from the depreciation reserve and hence the additions to the deferred-tax reserve, and (ii) normalized deferred-tax expense is impermissibly decoupled from the deferred-tax reserve. While this may be acceptable and required under the RCP, it is impossible for this mathematical, yet decoupled, approach to achieve the required compliance with the normalization rules.

Taxpayer provided tables in its submission with illustrated numbers, each with preceding explanatory text, to illustrate the computational approaches used in each of the three one-year test periods pursuant to the RCP, first by doing so for the first two of the years for which the computations satisfy the normalization requirements, and then for the third (attrition) year where decoupling is present.

An abbreviated description from Taxpayer is as follows:

In a GRC filing, the January 1 of Year 1 balances are based on company records (that is, based on actual balances) as most recently available along with estimates of future activity up to the Year 1 forecasted beginning balance. The Year 1 activity for asset additions, asset retirements, and depreciation expense is also based on company estimates. The December 31 of Year 1 balances for gross plant and depreciation reserve are simple roll-forward computations derived from these amounts. The December 31 of Year 1 balances also serve as the January 1 of Year 2 balances. Similarly, the Year 2 activity for asset additions, asset retirements, and depreciation expense is based on company estimates. The December 31 of Year 2 balances are simple roll-forward computations derived from these amounts and also serve as the January 1 of Year 3 balances.

The RCP requires Year 3 rate base to be forecasted by adding the difference between the Year 1 and Year 2 rate-base amounts to the Year 2 rate-base amount. The RCP's Year 3 approach applies to the entirety of rate base, including the gross plant, depreciation reserve, and deferred-tax reserve components. The independent requirement to prorate the future portion of the deferred tax reserve is not addressed in the RCP, but Taxpayer will continue to apply the mandatory provisions of § 1.167(l)-1(h)(6)(ii).

The use of a decoupled amount serving as a proxy for Year 3 "depreciation-reserve activity" is evident in the rolling forward of the December 31 of Year 2 balances (which also serve as the January 1 of Year 3 balances) with the Year 1 proxy amounts to obtain the December 31 of Year 3 balances. Of particular note is the Year 3 "depreciation-reserve activity" reflecting use of Year 1 "depreciation activity" as its proxy for Year 3 "depreciation expense," disregarding and decoupling from the Year 3 "cost-of-service depreciation expense." The Year 3 recoverable "depreciation expense" is computed pursuant to the RCP's cost-of-service depreciation RCP-escalation approach. The "depreciation expense" activity that enters into the rate-based "depreciation-reserve" December 31 Year 3 balance pursuant to the RCP is one number, however, at the same time the RCP uses a differing "cost-of-service depreciation expense" which demonstrates the forced mathematical inconsistency inherent in the RCP.

That is, the amount of Year 3 "depreciation expense" recoverable is one number, but the amount of implied depreciation expense to determine the "depreciation reserve" component of rate base is another. Further, the "depreciation reserve" at the end of Year 3 computed with reference to Year 3 recoverable depreciation expense would be one number, while the "depreciation reserve" at the end of Year 3 reflected in average Year 3 rate base is another. From either perspective, the "depreciation-reserve" component of Year 3 average rate base is decoupled from Year 3 recoverable cost-of-service "depreciation expense." Subsidiary believes that the RCP methodology to compute attrition year (Year 3) average rate base and recoverable cost-of-service depreciation expense does not comply with the § 168(i)(9)(B) deferred tax normalization requirement, and, in fact, exemplifies use of inconsistent estimates or projections as described in § 168(i)(9)(B)(ii). Moreover, Subsidiary contends that the decoupling of "depreciation expense" from the "depreciation reserve-component" of rate base (and, hence, the deferred-tax-reserve component of rate base) fails to comply with the deferred tax account computational rules of § 1.167(l)-1(h).

This decoupled "book depreciation" activity also implicates the consistency of the "deferred-tax component" of cost-of-service taxes and the "deferred-tax reserve" included in rate base by virtue of the fact that deferred-tax activity is intended to reflect the tax effect of the difference between "book depreciation" (decoupled by the RCP's methodology) and "tax depreciation." Further, the normalized "deferred-tax expense" (including the "tax side" of book-vs-tax depreciation differences) recoverable in Year 3 cost of service is computed in a manner that likewise decouples it from the implicit amount of Year 3 "deferred-tax activity" used to arrive at the amount of the

“deferred-tax-reserve” component of Year 3 rate base. Subsidiary contends that the computations of Year 3 recoverable “deferred tax expense” and the “deferred tax component” of average rate base do not comply with the § 168(i)(9)(A) deferred tax normalization requirement, the § 168(i)(9)(B) deferred-tax normalization requirement, or the deferred-tax-account computational rules of § 1.167(l)-1(h). In fact, Subsidiary believes this decoupling aspect of the RCP methodology further exemplifies use of inconsistent estimates or projections as described in § 168(i)(9)(B)(ii).

Finally, the mathematical result of Year 1 activity serving as a proxy for Year 3 activity is the case for all components of rate base other than deferred taxes. While the RCP's approach of escalating the Year 2 rate base is handled in the same manner for the “deferred-tax reserve” as it is for all other components of rate base (by adding to the amount of the Year 2 rate-base component the difference between the Year 1 and Year 2 rate-base amounts for that component), because § 1.167(l)-1(h)(6)(ii) requires future-period deferred-tax activity to be prorated, there is a necessary adjustment to the Year 1 amount also serving as the Year 3 amount. Although identification of the proxy used for the Year 3 pre-prorated deferred-tax activity is mathematically less straightforward owing to the layering on of the required proration, the bottom line is that the Year 3 amounts of “deferred-tax activity” in “cost-of-service tax expense” and pre-prorated in the “deferred-tax reserve” are nonetheless improperly decoupled under the RCP's methodology. Given that proration is an additional requirement when future periods are involved, and is not the cause of the decoupling that results by application of the RCP's methodology, only the requirement to continue to apply proration to future test periods is subject to the final portion of Ruling Request C.

In sum, should Commission insist on continued application of the RCP methodology that decouples the estimate of recoverable “depreciation expense” from the interrelated “depreciation reserve” rate-base computation, and that also decouples the estimate of “cost-of-service deferred tax expense” from the interrelated “deferred-tax reserve,” Subsidiary believes that the implementation of the attrition methodology would violate the deferred tax reserve normalization requirements of § 1.167(l)-1(h) and the consistency rules of § 168(i)(9).

In its testimony before Commission A in the GRC, Subsidiary expressed its concern that the decoupling approach inherent in the attrition methodology results in an impermissible decoupling of the amount of Year 3 “depreciation expense” recovered in cost of service and the Year 3 “deferred-tax-reserve” additions incorporated in the amounts used to compute Year 3 rate base. Indeed, Subsidiary observed that the decoupling approach cannot be reconciled with the terms of the deferred-tax-account computational rules of § 1.167(l)-1(h), let alone the consistency rules of § 168(i)(9). Accordingly, Subsidiary proposed that the “depreciation reserve” and the “deferred-tax reserve” in the Year 3 rate base calculation reflect the Year 3 “depreciation expense” and “deferred-tax activity” reflected in cost of service in order to achieve consistency and prevent a normalization violation.

The attrition-year methodology described above has yet to be implemented in rates. Moreover, Subsidiary and Consumer Advocate have agreed that it is not in the interest of Subsidiary or its customers to risk the adverse consequences of a normalization violation resulting in the loss of Subsidiary's ability to claim accelerated depreciation. Accordingly, the parties have agreed to submit this ruling request before the proposed rates with the Year 3 attrition allowance are put into effect on Date 5. Their Agreement provides that if the IRS concludes that the use of the Year 3 attrition methodology does not result in a normalization violation, Subsidiary will employ that method in setting rates going forward. In the event that the IRS does not issue the requested PLR prior to the implementation of Year 3 rates using the attrition methodology, the rates using the attrition calculations will be put into effect; however, Subsidiary will establish and maintain a "tracker," a form of memorandum account, to record the difference in the revenue requirement between the attrition methodology and Subsidiary's proposed method, thus enabling adoption of Subsidiary's method should the IRS later determine that the attrition method would violate the normalization rules.

Notwithstanding that rates calculated using the Year 3 attrition allowance methodology in this GRC have not yet been put into effect, this is not the first GRC in which Subsidiary has utilized the attrition methodology here at issue. Indeed, it has utilized that methodology since Year 4. In preparing for this GRC, however, Subsidiary observed for the first time that the attrition methodology was, in its view, fundamentally inconsistent with the deferred-tax-account computational rules of § 1.167(l)-1(h), as well as the normalization consistency rules of § 168(i)(9). Given that rates set in prior cycles are no longer subject to correction, in the current Year 5 GRC application, Subsidiary raised its concern regarding a potential normalization violation having occurred in prior years. Accordingly, Subsidiary is also seeking "inadvertent error" relief for the prior years were the IRS to determine that the attrition allowance methodology would violate the normalization rules were it to be implemented in this GRC. Subsidiary believes that the current GRC represents the "next available opportunity" to request inadvertent error relief within the meaning of Rev. Proc. 2017-47, Sec, 4.07. As such, continuing the historical methodology in the attrition year of the Year 5 GRC (i.e., Year 3) would not be an inadvertent error, but a normalization violation would not occur given the establishment and contemplated use of the above-described "tracker."

In the current GRC, in responding to the concerns articulated by Subsidiary, Consumer Advocate did not provide a technical analysis of the potential normalization consequences of the use of the attrition adjustment to calculate the third-year rate base while decoupling the depreciation reserve and deferred-tax reserve from their respective cost-of-service elements. Rather, it noted that Subsidiary and other large State regulated Resource utilities have utilized this attrition procedure for several years without objection or assertion of a normalization violation by taxpayers or the IRS. Additionally, it stated that a correction of the methodology was unnecessary because it would have a de minimis impact on Subsidiary's revenue requirement. Moreover, it asserted a different approach as proper to address Subsidiary's concern of the impact of a normalization violation on its customers.

As noted above, to avoid the potential adverse consequences of a normalization violation, Subsidiary and Consumer Advocate agreed for Subsidiary to submit this ruling request regarding the propriety of the third-year attrition adjustment under the normalization rules of § 168(i)(9) and the relevant normalization regulations.

RULINGS REQUESTED

A. The implementation of a final rate order mandating the continued use of the third-year attrition adjustment with its decoupling of depreciation expense in the depreciation reserve and deferred-tax expense in the deferred-tax reserve, both of which are included in rate base, from cost-of-service depreciation expense and deferred-tax expense would violate the deferred-tax-account computational rules of § 1.167(l)-1(h)(l).

B. The implementation of a final order mandating the continued use of the third-year attrition adjustment would violate the consistency rules of § 168(i)(9)(B).

C. The elimination or modification of the third-year attrition adjustment to ensure consistency amongst third-year rate base, specifically its depreciation reserve and deferred-tax reserve components, depreciation expense, and tax expense in the current GRC (the "next available opportunity") either before the Year 3 rates are put into effect or through utilization of the tracker mechanism to eliminate the effect of noncompliant rates prior to the issuance of a ruling would satisfy the requirements of Rev. Prov. 2017-47 such that Subsidiary would be entitled to inadvertent-error safe-harbor treatment, thus preserving its right to claim accelerated depreciation on all of its public utility property subject to Commission A jurisdiction. Where a future test period (or a part-historical and part-future test period) is involved, the proration rules shall then be applied to the properly computed deferred tax reserve component of rate base.

LAW AND ANALYSIS

Section 168(f)(2) 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.

Section 168(i)(10) defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A),

property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in § 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body that has the power to approve such rates, even if the regulatory body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), expand the definition of regulated rates. The expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former § 167. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses 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. Thus, for purposes of applying the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires a 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 for 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), then the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 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 § 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 § 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 (hereinafter referred to as the “Consistency Rule”).

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 the definition in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) 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 § 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 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property 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) 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.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the

expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.46-6(b)(4) makes clear that cost of service or rate base is considered to have been reduced by reason of all or a portion of a credit if such reduction is done in an indirect manner. Section 1.46-6(b)(4)(iii) provides that a type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances, including the record of the proceeding, the regulatory body's orders, and the anticipated effect of the ratemaking decision on the cost of service or rate base.

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical test period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period.

Section 1.167(l)-1(h)(6)(ii) provides if, in determining depreciation for ratemaking tax expense, the test period used is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

As discussed above, section 168(f)(2) 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.

However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581. See also, Rev. Proc. 2017-47, 2017-38 I.R.B. 233, September 18, 2017.

Rev. Proc. 2017-47 provides that in the case of an "inadvertent error" resulting in a normalization violation, taxpayers are entitled to safe-harbor treatment excusing the violation, provided that correction of the error, once identified, is sought at the "first available opportunity."

Section 1.167(l)-1(h)(l) specifically requires additions to the deferred-tax reserve to be the product of the statutory tax rate multiplied by the difference between "depreciation expense" for book and tax purposes. Section 1.167(l)-1(h)(2) further provides that the reserve shall not be reduced until, and in an amount reflective of the effect on actual tax liability, of book depreciation exceeding tax depreciation.

The attrition-year methodology is inconsistent with the deferred-tax-account computational rules of the foregoing regulations by decoupling cost-of-service "depreciation-expense" calculations from the Year 3 rate base. As noted above, the RCP's mathematical approach for computing Year 3 rate base assumes that Year 3 "depreciation expense" and "deferred-tax expense" activity for these amounts used in cost of service for Year 3 rates is the same as the Year 1 activity for these amounts, even though Year 3 activity is obviously not the same as Year 1 activity. It would be solely by sheer coincidence were the Year 3 proxy amounts and the actual Year 3 activity the same, and in the instant GRC, they are not.

The decoupling of cost-of-service "deferred-tax expense" from the additions to the "deferred-tax reserve" (and ultimately, rate base), is inconsistent with the express terms for making permissible additions or reversals of the deferred-tax reserve under the deferred-tax-account computational rules of § 1.167(l)-1(h). The net effect of the attrition-year methodology is that the deferred-tax reserve does not represent the deferral of taxes attributable to the use of different methods of depreciation for rate-making and tax purposes on the same rate base.

As described above, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for rate-making 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 § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 167 using the method, period, first- and last-year convention, and salvage value used to compute regulated depreciation expense under § 168(i)(9)(A)(ii), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes

resulting from such difference. In this manner the statue provided for a linkage, or coupling, between the cost-of-service elements (depreciation expense and tax expense) and the rate-base elements (the depreciation reserve and the deferred-tax reserve). Congress also added § 168(i)(9)(B) described above and known as the Consistency Rule. Taken together, § 168(i)(9) establishes certain fundamental relationships amongst four rate-making elements impacted by depreciation, comprising two cost-of-service elements (depreciation expense and tax expense) and two rate-base elements (rate base and the deferred-tax reserve).

Although the escalation methodology used to arrive at Year 3 rate base and depreciation expense is based upon the difference between these amounts for the first two years, the resulting expense amount cannot be reconciled with the addition to the reserve for deferred taxes. The inherent mathematical differences in using the change between Year 1 and Year 2 amounts for averaged rate base versus cost escalation results in a decoupling from the rate base (including the reserve for deferred taxes) and the cost-of-service depreciation expense and tax expense. This violates the intent and mandate of the Consistency Rule.

RULINGS

A. The implementation of a final rate order mandating the continued use of the third-year attrition adjustment with its decoupling of depreciation expense in the depreciation reserve and deferred-tax expense in the deferred-tax reserve, both of which are included in rate base, from cost-of-service depreciation expense and deferred-tax expense would violate the deferred-tax-account computational rules of § 1.167(l)-1(h)(1).

B. The implementation of a final order mandating the continued use of the third-year attrition adjustment would violate the consistency rules of § 168(i)(9)(B).

C. The elimination or modification of the third-year attrition adjustment to ensure consistency amongst third-year rate base, specifically its depreciation reserve and deferred-tax reserve components, depreciation expense, and tax expense in the current GRC (the "next available opportunity") either before the Year 3 rates are put into effect or through utilization of the tracker mechanism to eliminate the effect of noncompliant rates prior to the issuance of a ruling would satisfy the requirements of Rev. Prov. 2017-47 such that Subsidiary would be entitled to inadvertent-error safe-harbor treatment, thus preserving its right to claim accelerated depreciation on all of its public utility property subject to Commission A jurisdiction. Where a future test period (or a part-historical and part-future test period) is involved, the proration rules shall then be applied to the properly computed deferred tax reserve component of rate base.

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 a penalty of perjury statement 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.

This letter is being issued electronically in accordance with Rev. Proc. 2020-29, 2020-21 I.R.B. 859. A paper copy will not be mailed to Taxpayer.

Sincerely,

/S/

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

Enclosure: Copy for § 6110 purposes

Cc: