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Person To Contact:
, ID No.

Telephone Number:

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Date:
April 17, 2018

LEGEND:

Taxpayer =

X =
Parent =
State A =
State B =
State C =
State D =
Commission A =
Commission B =

Commission C =
Intervenor 1 =
Intervenor 2 =

Order 1 =
Order 2 =
Order 3 =
Case =
a =
b =
c =
d =
e =
f =
g =

h	=
i	=
j	=
k	=
l	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Director	=

Dear :

This letter responds to Parent's request, made on behalf of Taxpayer, dated October 19, 2017, for a ruling on the application of the Normalization Rules of the Internal Revenue Code (Code) to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer is an investor-owned regulated utility incorporated in State B and State C. Taxpayer is a wholly-owned subsidiary of X, a State D limited liability company classified as a corporation for income tax purposes. X is wholly-owned by Parent. Taxpayer is a member of Parent's consolidated group that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting.

Taxpayer is engaged in the purchase, transmission, distribution, and sale of electric energy in State A and State B. Taxpayer is subject to regulation with respect to terms and conditions of services by Commission A, Commission B, and Commission C. Each

of these regulators establishes Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of Accumulated Deferred Federal Income Taxes (ADFIT) that is attributable to the accelerated depreciation reflected on both its State A and State B regulated books of account. In its general rate cases, Taxpayer reduces its rate base upon which its return component was computed by its ADFIT balance.

Taxpayer has generated significant net operating losses ("NOLs") in a number of prior tax years and continues to have an NOL carryforward ("NOLC") balance. To accurately reflect the economics of this NOLC, Taxpayer has recorded a deferred tax asset ("DTA") on both its State A and State B regulated books of account. Taxpayer properly takes this DTA into account when computing the ADFIT balance by which it reduces its rate base and both Commission A and Commission B have accepted this treatment.

Prior to Year 4, Taxpayer had been a member of an affiliated group of corporations of which X was the common parent ("X Group"). The members of the X Group had, for many years, joined in the filing of a consolidated federal income tax return. By Year 3, the X Group had been under IRS audit for a considerable period of time with respect to its federal income taxes for Year 1 through Year 2. The audit resulted in proposed adjustments, both positive and negative, to the taxable income of a number of X Group members, including both regulated and non-regulated members.

On Date 1, the IRS and X Group entered into a settlement ("IRS Settlement"). The IRS Settlement resulted in a net positive adjustment to the X Group's consolidated taxable income during the audit period which absorbed a portion of the then-existing consolidated NOLC. Of the consolidated NOLC absorbed, approximately $a was attributable to Taxpayer. Under the tax sharing agreement for the X Group Taxpayer received approximately $b in net payments during Date 4 and Date 5 from the X Group for use of Taxpayer's NOLC.

In Date 2, the month subsequent to the IRS Settlement being finalized, the results were recorded in the appropriate DTA accounts on Taxpayer's books and records. The recordation resulted in a reduction in Taxpayer's NOLC-related DTA. By reducing Taxpayer's DTA, this recordation increased Taxpayer's net ADFIT balance.

State A Ratemaking

On Date 7, Taxpayer filed an application with Commission A to request an increase in its retail rates for electricity. Taxpayer's application used a 12-month test period ending

Date 3, with an effective date of Date 8 for the rates established in this proceeding. Thus, the test period was an historic test period. In computing its rate base, Taxpayer employed a 13-month averaging convention for all of the constituent elements, including ADFIT. During the proceeding, the proper calculation of the ADFIT balance by which rate base should be reduced became an issue in dispute.

In computing the amount of ADFIT by which rate base should be reduced, Taxpayer applied its applicable rate base convention, a 13-month average, to its monthly ADFIT balances for the test period and multiplied this amount by the State A distribution jurisdictional factor (c%). In its general rate case, Taxpayer reflected the impact of the IRS Settlement on Taxpayer's ADFIT balance as being $d. Applying the jurisdictional factor to this ADFIT impact, Taxpayer calculated that approximately $e was attributable to its State A electric distribution business. Since the IRS Settlement was recorded on Date 2, the last month of the test period, using the regulatory convention employed for all other elements of rate base, only $1/13^{th}$ of the effect of the IRS Settlement ($e/13 or approximately $f) was included in the Taxpayer's calculation of the ADFIT balance by which it reduced rate base.

A third party intervenor (Intervenor 1) proposed to adjust Taxpayer's computation of ADFIT on account of the impact of the IRS Settlement. Specifically, Intervenor 1 proposed to treat the full impact of the IRS Settlement as a reduction in Taxpayer's ADFIT balance. Thus, Intervenor 1 proposed to take into account not just the $f reduction Taxpayer reflected in its rate base calculation but an additional $g, such that the entire jurisdictional impact of the IRS Settlement ($e) was incorporated into rates.

On Date 10, Commission A issued Order 1 in which it adopted Intervenor 1's proposed ADFIT adjustment based on the proposition that the impact of the IRS Settlement is "known" and will continue through the rate effective period. On Date 11, Taxpayer filed a motion in which Taxpayer asserted its view that incorporating the treatment of the IRS Settlement proposed by Intervenor 1 would constitute a violation of the Normalization Rules. In response to Taxpayer's filing, on Date 12, Commission A issued Order 2 in which it directed Taxpayer to request a Private Letter Ruling ("PLR") from the Service to clarify the impact of the normalization rule within the context of Order 2.

State B Ratemaking

On Date 9, Taxpayer filed an application with Commission B to request an increase in its retail rates for electricity. This application was considered by Commission B in Case. Taxpayer's application used a 12-month test period ending Date 6, with an effective date of Date 14 for the rates established in this proceeding. Thus, the test period was an historic test period. In computing its rate base, Taxpayer employed a 13-month averaging convention for all of the constituent elements. ADFIT was also computed by Taxpayer based on the 13-month averaging convention.

In computing the amount of ADFIT by which rate base should be reduced, Taxpayer applied its applicable rate base convention, a 13-month average, to its monthly ADFIT balances for the test period and multiplied this amount by the State B distribution jurisdictional factor (h%). In basing the test year ADFIT balance on the 13-month averaging convention, Taxpayer applied the jurisdictional factor to the impact of the IRS Settlement detailed above. In its filings in Case, Taxpayer proposed that the impact of the IRS Settlement on Taxpayer's ADFIT balance should be $i. Applying the jurisdictional factor to this ADFIT impact, Taxpayer calculated that approximately $j was attributable to its State B electric distribution business. Since the IRS Settlement was recorded on Date 2, using the regulatory convention employed for all other elements of rate base, only 4/13th of the effect of the IRS Settlement or approximately $k was included in the Taxpayer's calculation of the ADFIT balance by which it reduced rate base.

A third party intervenor (Intervenor 2) proposed to adjust Taxpayer's computation of ADFIT on account of the impact of the IRS Settlement. Specifically, Intervenor 2 proposed to treat the full impact of the IRS Settlement as a reduction in Taxpayer's ADFIT balance (without application of the 13-month averaging convention). Intervenor 2 characterized the proposed adjustment as "annualizing" the impact of the IRS Settlement to take into account not just the reduction Taxpayer reflected in its rate base calculation but an additional $l such that the entire jurisdictional impact of the IRS Settlement would be incorporated into rates. Intervenor 2 indicated that while the reduction in the NOL DTA was not booked by the Taxpayer until Date 2, the NOL DTA was on the Taxpayer's books before the beginning of the test year.

Taxpayer contested this proposed adjustment asserting that its implementation would constitute a violation of the Normalization Rules. In response to Taxpayer's filings, on Date 13, Commission B issued Order 3 in which it directed that the Taxpayer to request a PLR from the Service to clarify the impact of the Normalization Rules before Commission B finally decides whether to annualize the cash that Taxpayer received on Date 2 as part of the IRS Settlement.

Taxpayer requests that we rule as follows:

Whether, the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is acceptable under the Normalization Rules.

Law and Analysis

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods of 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).

In order to use a normalization method of accounting, § 168(i)(9)(A) requires that 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, 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.

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. This is known as the Consistency Rule.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the procedures and adjustments used in ratemaking to calculate elements in rate base, depreciation expense, tax expense, and the reserve for deferred taxes. In this case, the IRS settlement has an effect on Taxpayer's ADFIT balance and the Taxpayer, along with Commission A and Commission B, agree that the settlement must be taken into account in setting Taxpayer's rates. The only question is whether the same convention used to calculate other elements of rate base, including ADFIT, a 13-month averaging convention, must also apply to calculate the effect of the IRS Settlement, or whether a different convention may apply to this element. Using the same convention would result in the consistent calculation of Taxpayer's tax expense, depreciation expense, and ADFIT as required by § 168(i)(9)(B). Applying a different regulatory convention solely to calculate the effect of the IRS Settlement would not satisfy the requirements of § 168(i)(9)(B) and the Consistency Rule.

Conclusion

We conclude that the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is not acceptable under the Normalization Rules.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

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

Sincerely,

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