Internal Revenue Service

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In Re:

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-117557-19
Date:
January 23, 2020

LEGEND:

Taxpayer =

Parent =

State A =

Commission =

Order =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

g =

Dear :

This letter responds to a request for a private letter ruling dated July 26, 2019, and submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (together, the "Normalization Rules") regarding the scope of the deferred tax normalization requirements in connection with a Consent Agreement related to a Form 3115, *Application for Change in Accounting Method*, filed that was approved for the Year 1 tax year. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer files a consolidated federal income tax return on a calendar year basis with its affiliates, including Parent. Taxpayer uses an accrual method of accounting as its overall method of accounting.

Parent is a water and wastewater utility company. Taxpayer is the regulated water/wastewater utility subsidiary affiliate that operates in State A. Prices charged by Taxpayer are set by the Commission in the manner described in this letter.

Commission sets rates that Taxpayer may charge for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings and infrastructure surcharge proceedings.

For general rate case proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation, and a recovery of operating expenses, including depreciation expense, property tax expense, salary expense, and income tax expense. In setting the allowed return for the utilities that it regulates, Commission treats accumulated deferred income

tax liabilities (ADIT) as zero-cost capital in the computation of a weighted-average costs of capital to be applied to a rate base computation that is not reduced by ADIT.

The issues presented in this ruling request are a result of the following two separate but related proceedings (collectively referred to as "Rate Proceeding" throughout the ruling request):

- Investigation into the impacts of the Tax Cuts and Jobs Act of 2017 ("TJCA" or "Act") and possible rate implications initiated by the Commission on Date 1 with respect to all jurisdictional rate-regulated, investor-owned utilities.
- Petition to increase its rates and charges for water utility service initiated by Taxpayer on Date 2.

On Date 1, the Commission initiated an investigation to allow the Commission to consider the impacts and resulting benefits from the Act and how any resulting benefit should be realized by customers.

In general, subject to future guidance expected to be issued by the Service related to the excess accumulated deferred income taxes (EADIT) normalization rules, Taxpayer and the other parties are generally in agreement as to which specific timing differences and associated ADIT and EADIT are and are not subject to normalization requirements. The only disputes that exist are related to the Taxpayer's timing difference with respect to its tax-only repair and maintenance deductions. The disagreement with regard to repair-related EADIT is due to differing interpretations of the Consent Agreement that Parent received from the Service on Date 3, on behalf of itself and various affiliates, including Taxpayer, with respect to changes in tax methods of accounting for costs to repair and maintain tangible property and for dispositions of certain tangible depreciable property described in this letter.

On Date 4, parties to the Rate Proceeding entered into a settlement agreement. On Date 5, the Commission approved the settlement ("Order"). Rates became effective on Date 6 and were based on a test period ending Date 7. The settlement agreement resolved both the general rate case and the TCJA case, subject to clarification of the uncertainty described in this letter concerning the scope of the deferred tax normalization rules. Because of the uncertainty related to the Consent Agreement described in this letter, a condition of the Order permits Taxpayer to submit this ruling request.

Specifically, the Order provides, in part, that the parties have agreed in the pending rate case that, for purposes of certain rates, Taxpayer will use the estimate of EADIT which produces a result that is approximately the same as an estimate using ARAM for the entirety of Taxpayer's EADIT. The parties further agreed that Taxpayer will seek a private letter ruling from the Service requesting a determination whether the Commission has the discretion to order an amortization of EADIT related to Taxpayer's

tax deductions for repairs that is faster than the average rate assumption method (ARAM). The parties agreed the ruling request is not an opportunity for advocacy for one outcome or another and that the ruling request will be drafted using neutral and unbiased language.

As noted, Taxpayer and its affiliates changed their tax methods of accounting for costs to repair and maintain tangible property and for dispositions of certain tangible depreciable property in a prior tax year. The year of change was Year 1, and Taxpayer's net deductible § 481(a) adjustment was approximately $a. The Consent Agreement granting permission for the tax accounting method changes states that this amount represents a netting of the net negative § 481(a) adjustment for maintenance and repairs with the net positive § 481(a) adjustment for dispositions. The Consent Agreement described the netting as a one-time exception allowed to Taxpayer for the year of change based on its particular situation. The net deductible § 481(a) adjustment for the repair-related change in tax method of accounting was $b and the net taxable § 481(a) adjustment for the disposition-related change in tax method of accounting was $c.

The Consent Agreement provides nine conditions that Taxpayer must satisfy including the following condition, at issue, related to the normalization rules:

9) If any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A):

- (A) A normalization method of accounting (within the meaning of § 168(i)(9), former § 168(e)(3)(B), or former § 167(l)(3)(G), as applicable) must be used for such public utility property;
- (B) As of the beginning of the year of change, the taxpayer must adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to such public utility property; and
- (C) Within 30 calendar days of filing the federal income tax return for the year of change or of receiving this letter ruling, whichever is later, the taxpayer must provide a copy of its Form 3115 (and any additional information submitted to the Service in connection with such Form 3115) to any regulatory body having jurisdiction over such public utility property.

The parties to the Rate Proceeding generally agree that the EADIT related to the repairs method change and ongoing repairs deductions are not subject to the normalization requirements under the applicable statute and regulations. Notwithstanding that agreement, however, Taxpayer is party to the Consent Agreement that has very specific terms and conditions, including the condition nine above. Taxpayer and other parties disagree whether the condition nine applies to Taxpayer's request to change its method of accounting for repairs pursuant to § 162, or to Taxpayer's request to change its units of property for determining dispositions under

§ 168. Further, depending upon how this issue is answered, there is an additional question of whether the EADIT that existed immediately prior to the beginning of the year of change for the changes in tax method of accounting and resulted from depreciation method and life differences remains subject to the deferred tax normalization rules after implementation of the new tax method of accounting and recognition of the § 481(a) adjustment.

Since the beginning of Year 1, the year of change for the new tax method of accounting for repairs, and through the end of Year 2, Taxpayer has deducted approximately $d of costs as repairs under § 162. These amounts were capitalized and are depreciable for regulatory and financial reporting purposes. No income tax depreciation was claimed on any of the $d of costs claimed as repairs under § 162 of the Code. The gross tax-only repair amounts are originating timing differences. During these years, approximately $e of depreciation was reported for regulatory and financial reporting purposes with respect to these costs. The book-only depreciation related to the tax-only repairs has been the mechanism that Taxpayer was using prior to the TCJA to reverse this timing difference. Similarly, the deductible repair-related component of the § 481(a) adjustment of $f constituted an originating timing difference and the book-only depreciation related to this amount has been the mechanism to reverse this timing difference. Through the end of Year 2, approximately $g of book depreciation was reported for regulatory and financial reporting purposes with respect to the repair-related component of the § 481(a) adjustment.

The deferred tax normalization issues for which Taxpayer requests rulings are:

1) Whether net EADIT attributable to expenditures deducted as repairs for tax purposes under § 162 after the beginning of the year of change through the end of Year 2 pursuant to Taxpayer's Consent Agreement and capitalized and depreciated for regulatory and financial reporting purposes is subject to the normalization rules of § 168(i)(9)(A).

2) Whether net EADIT attributable to expenditures deducted as repairs as the deductible (negative) component of the net § 481(a) adjustment recognized in Year 1 related to the change in tax method of accounting for repairs (net of tax depreciation deducted under the former tax method of accounting) pursuant to Taxpayer's Consent Agreement is subject to the normalization rules of § 168(i)(9)(A).

3) Whether EADIT associated with depreciation method and life differences arising prior to the beginning of the year of change with respect to property that was public utility property under the former method of accounting and for which its remaining tax basis was deducted as part of the repair component of the net § 481(a) adjustment pursuant to Taxpayer's Consent Agreement remains subject to the normalization rules of § 168(i)(9)(A).

RULINGS REQUESTED

(1)

The net EADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10) pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) and is not required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement. As such return of net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

or

The net EADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10) pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9), but is required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement. As such, return of net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules, but would be a violation of the Consent Agreement.

(2)

For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net EADIT resulting from the repair-related component of the § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9), and is not required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement. As such, return of net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

or

For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net EADIT resulting from the repair-related component of the § 481(a) adjustment is subject to the normalization method of accounting within the meaning of § 168(i)(9), or is required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement.

As such, return of EADIT related to such timing difference faster than ARAM would be a violation of the EADIT normalization rules and would be a violation of the Consent Agreement.

(3)

For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net depreciation-related ADIT that existed prior to the changes in tax methods of accounting for repairs and dispositions remains subject to the normalization method of accounting within the meaning of § 168(i)(9) even after implementation of the new tax method of accounting. As such, return of any net EADIT related to such timing difference faster than ARAM would be a violation of the EADIT normalization rules. Under the circumstances described above, return of any EADIT related to such timing difference faster than ARAM would not be a violation of the Consent Agreement.

or

For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net depreciation-related ADIT that existed prior to the changes in tax methods of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) even after implementation of the new tax method of accounting and is not required to be normalized pursuant to the Consent Agreement. As such, return of any net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

or

For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net depreciation-related ADIT that existed prior to the changes in tax methods of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax method of accounting. However, pursuant to the Consent Agreement, a normalization method of accounting is required. As such, return of any net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules, but would be a violation of the Consent Agreement.

LAW AND ANALYSIS

Section 1.167(l)-1(a)(1) provides that the normalization requirements of former § 167(l) with respect to public utility property defined in former § 167(l)(3)(A) 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 method of 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.

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. *See also* § 2.05(1) of Rev. Proc. 97-27, 97-27, 1997-1 C.B. 680 (the operative method change revenue procedure at the time Taxpayer filed its Form 3115).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the period of limitation on assessment under § 6501(a). *Suzy's Zoo v. Commissioner*, 114 T.C. 1, 13 (2000), *aff'd*, 273 F.3d 875, 884 (9th Cir. 2001); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 912 (1983), *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968), *Spang Industries, Inc. v. United States*, 6 Cl. Ct. 38, 46 (1984), *rev'd on other grounds* 791 F.2d 906 (Fed. Cir. 1986). *See also Mulholland v. United States*, 28 Fed. Cl. 320, 334 (1993) (concluding that a court has the authority to review the taxpayer's threshold selection of a method of accounting *de novo*, and must determine, *ab initio*, whether the taxpayer's reported income is clearly reflected).

Sections 481(c) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner, and subject to the conditions, agreed to by the Service and a taxpayer. Section 1.446-1(e)(3)(i) authorizes the Service to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). *See also* § 5.02 of Rev. Proc. 97-27.

When there is a change in method of accounting to which § 481(a) is applied, § 2.05(1) of Rev. Proc. 97-27 provides that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Taxpayer’s ruling request # 3 pertains to whether EADIT associated with depreciation method and life differences arising prior to the beginning of the year of change (Year 1) with respect to property that was public utility property under the former method of accounting and for which its remaining tax basis was deducted as part of the repair component of the net § 481(a) adjustment pursuant to Taxpayer’s Consent

Agreement remains subject to the normalization rules of § 168(i)(9)(A). Beginning with the year of change, Taxpayer's Consent Agreement granted Taxpayer permission to change its method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162.

Condition nine of the Consent Agreement provides that if any item of property subject to the Form 3115 is public utility property within the meaning of § 168(i)(10), a normalization method of accounting (within the meaning of § 168(i)(9)) must be used for such public utility property. Public utility property (within the meaning of § 168(i)(10)) is a depreciable asset. Consequently, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years.

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed by Taxpayer, and income for the year of change and the following taxable years must be determined under Taxpayer's new method of accounting as if the new method had always been used. *See* § 481(a); § 1.481-1(a)(1); and § 2.05(1) of Rev. Proc. 97-27. In other words: (1) Taxpayer's new method of accounting is implemented beginning in the year of change; (2) Taxpayer's old method of accounting used in the taxable years preceding the year of change is not disturbed; and (3) Taxpayer takes into account a § 481(a) adjustment in computing taxable income to offset any consequent omissions or duplications.

Accordingly, for public utility property in service as of the end of the taxable year immediately preceding the year of change (Year 1), the depreciation-related ADIT existing prior to the year of change for the changes in methods of accounting subject to the Consent Agreement does not remain subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax methods of accounting in the year of change and subsequent taxable years.

As stated previously, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, in regard to ruling request 2, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

Lastly, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible

under § 162 and for which depreciation is not allowable. Accordingly, in regard to ruling request 1, net EADIT attributable to expenditures deducted as repairs for tax purposes under § 162 after the beginning of the year of change through the end of Year 2 pursuant to Taxpayer's Consent Agreement and capitalized and depreciated for regulatory and financial reporting purposes is not subject to the normalization rules of § 168(i)(9)(A)

Based on the foregoing, we conclude that:

For ruling request # 1, the net EADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10) pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) and is not required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement. As such return of net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

For ruling request # 2, for any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net EADIT resulting from the repair-related component of the § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9), and is not required to be treated as subject to a normalization method of accounting pursuant to the Consent Agreement. As such, return of net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

For ruling request # 3, for any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax methods of accounting subject to Taxpayer's Consent Agreement, the net depreciation-related ADIT that existed prior to the changes in tax methods of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) even after implementation of the new tax method of accounting and is not required to be normalized pursuant to the Consent Agreement. As such, return of any net EADIT related to such timing difference faster than ARAM would not be a violation of the EADIT normalization rules and would not be a violation of the Consent Agreement.

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. Specifically, we are not ruling on the ADIT resulting from the disposition-related § 481(a) adjustment and related to the

restored tax basis of public utility property that was treated as disposed under the old method of accounting but is not treated as disposed under the new method of accounting.

To note, the EADIT at issue in this request does not address the excess tax reserves resulting from the corporate tax rate decrease in the Tax Cuts and Jobs Act (TCJA), Pub. L. 115-97 (131 Stat 2054). The EADIT at issue is only that as described in this letter ruling.

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: