Exhibit No.:	
Issues:	ISRS Accumulated Deferred Income Taxes, Normalization
Witness:	John R. Wilde
Exhibit Type:	Direct
Sponsoring Party:	Missouri-American Water Company
Case No.:	WO-2019-0184
Date:	May 7, 2019

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WO-2019-0184

FILED
MAY 21 2019
Missouri Public Service Commission

DIRECT TESTIMONY

OF

JOHN R. WILDE

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

Company ~~WO-2019-0184~~ Exhibit No. 1
Date 5/17/19 Reporter LmB
File No. WO-2019-0184

DIRECT TESTIMONY
JOHN R. WILDE
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WO-2019-0184

TABLE OF CONTENTS

I. Introduction....................2

II. ISRS....................3

III. Normalization....................4

IV. MAWC ISRS Case WO-2018-0373....................8

V. Private Letter Ruling Request....................10

VI. Impact on MAWC and its Customers....................11

VII. Staff Recommendation....................14

VIII. Consent Agreement....................17

IX. Net Operating Loss Carryover....................19

X. Other Private Letter Rulings....................20

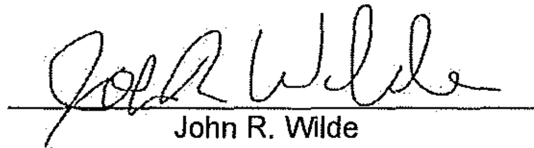
BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN WATER COMPANY'S PETITION TO ESTABLISH AN INFRASTRUCTURE REPLACEMENT SURCHARGE	)))))	**CASE NO. WO-2019-0184**

AFFIDAVIT OF JOHN R. WILDE

John R. Wilde, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Direct Testimony of John R. Wilde"; that said testimony and schedules were prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge.



John R. Wilde

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 17th **day of** May **2019.**

Notary Public

My commission expires:

MARY BETH HERCULES
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires April 26, 2020
Commission # 96546828

DIRECT TESTIMONY

JOHN R. WILDE

1 **I. INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. My name is John R. Wilde, and my business address is One Water Street, Camden, NJ,
4 08102.
5

6 **Q. By whom are you employed and in what capacity?**

7 A. I am employed by American Water Works Service Company, Inc. ("Service
8 Company") as Vice President, Tax Strategy and Compliance. The Service Company
9 is a subsidiary of American Water Works Company, Inc. ("American Water") that
10 provides services to American Water's subsidiaries, including Missouri-American
11 Water Company ("Missouri-American," "MAWC" or the "Company").
12

13 **Q. Please outline your educational background and professional experience.**

14 A. I graduated from Saint Norbert College, De Pere, Wisconsin in 1984 with a Bachelor
15 of Business Administration Degree in Accounting. I have a graduate certificate in state
16 and local taxation, as well as a Master of Science Degree in Taxation from the
17 University of Wisconsin-Milwaukee. I have 35 years of experience as a tax and
18 accounting professional serving utilities with regulated operations in multiple states.
19 Before coming to American Water, I spent fifteen years as the head of tax for a
20 corporate group (WEC Energy Group, Inc., formerly Integrys Energy Group, Inc.) that
21 had six utilities with operations in four states.

1

2 **Q. Have you previously testified before a regulatory body?**

3 A. Yes. I provided testimony before the Missouri Public Service Commission
4 ("Commission") in MAWC's last general rate case (WR-2017-0285), in MAWC's
5 Accounting Authority Order case related to property taxes (WU-2017-0351), and in
6 MAWC's last Infrastructure System Replacement Surcharge ("ISRS") case (WO-
7 2018-0373). Additionally, I have testified before the Federal Energy Regulatory
8 Commission, the Public Service Commission of Wisconsin, the Michigan Public
9 Service Commission, the Virginia State Corporation Commission, the Illinois
10 Commerce Commission, the Indiana Utility Regulatory Commission, the Kentucky
11 Public Service Commission, the Minnesota Public Utilities Commission, the Virginia
12 State Corporation Commission, the California Public Utilities Commission, the
13 Tennessee Public Utility Commission, the West Virginia Public Service Commission,
14 and the Pennsylvania Public Utility Commission.

15

16 **Q. What is the purpose of your testimony in this proceeding?**

17 A. The purpose of my Direct Testimony is to address Staff's treatment of net operating
18 losses ("NOLs") as reflected in the Staff Recommendation filed by the Staff of the
19 Commission ("Staff), as it relates to normalization accounting. I will also provide an
20 update on the Company's request for a Private Letter Ruling from the Internal Revenue
21 Service on the normalization issues raised in the prior ISRS case (WO-2018-0373).

22

23 **II. <u>ISRS</u>**

24 **Q. What revenues must the Commission capture in the ISRS process?**

1 A. Section 393.1000(1), RSMo, describes "Appropriate pretax revenues" as follows:

2 The revenues necessary to produce net operating income equal to:
3
4 (a) The water corporation's weighted cost of capital multiplied by the net
5 original cost of eligible infrastructure system replacements, including recognition of
6 accumulated deferred income taxes and accumulated depreciation associated with
7 eligible infrastructure system replacements which are included in a currently effective
8 ISRS; and
9 (b) Recover state, federal, and local income or excise taxes applicable to such
10 income; and
11 (c) Recover all other ISRS costs.
12
13 "ISRS costs" are further described as "depreciation expenses and property taxes that
14 will be due within twelve months of the ISRS filing." Section 393.1000(5), RSMo.
15

16 **Q. What is included in "Accumulated Deferred Income Taxes"?**

17 A. Accumulated Deferred Income Taxes include both Deferred Tax Assets and Deferred
18 Tax Liabilities.

19

20 ## III. NORMALIZATION

21 **Q. What are the normalization provisions of the Internal Revenue Service Code?**

22 A. The normalization provisions are recently addressed in PL 115-97, signed into law
23 December 22, 2017 (otherwise known as "TCJA"), under Section 1561(d) and prior to
24 that in the Tax Act of 1986, Section 203(E)9A. The information is codified under
25 Internal Revenue Code 168(i)(9)(A). It states as follows:

26 *In order to use a normalization method of accounting with respect to*
27 *any public utility property-*
28 *(i) the taxpayer must, in computing its tax expense for purposes of establishing*
29 *its cost of service for ratemaking purposes and reflecting operating results in*
30 *its regulated books of account, use a method of depreciation with respect to*
31 *such property that is the same as, and a depreciation period for such property*
32 *that is no shorter than, the method and period used to compute its depreciation*
33 *expense for such purposes; and*

1 *(ii) if the amount allowable as a deduction under this section with respect to*
2 *such property differs from the amount that would be allowable as a deduction*
3 *under section 167 (determined without regard to section 167(1)) using the*
4 *method (including the period, first and last year convention, and salvage value)*
5 *used to compute regulated tax expense under clause (i), the taxpayer must make*
6 *adjustments to a reserve to reflect the deferral of taxes resulting from such*
7 *difference.*
8
9 Section 168(i)(9)(B)(i) of the Internal Revenue Code provides that one way the
10 requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for
11 ratemaking purposes, uses a procedure or adjustment which is inconsistent with such
12 requirements.
13 To summarize, a utility is allowed recovery of total income tax expense, including
14 current and deferred income tax expense, in its Cost of Service amount. Cost of Service
15 includes regulatory book depreciation expense. To the extent that a Company is
16 allowed additional accelerated depreciation expense for tax purposes (over regulatory
17 book depreciation) and can defer more tax costs paid to the IRS in the current year, to
18 be paid in subsequent years, this deferred amount (or ADIT) is a reduction to rate base
19 and the Company is not allowed a return on this amount. The intent of Congress in
20 creating the normalization rules, is to provide the utility an interest free source of funds
21 to invest in utility property. To the extent that the utility does not receive this interest
22 free source of funds because taking the accelerated depreciation deduction causes a
23 taxable loss, that taxable loss needs to be included in the numbers so that the customers
24 are not benefiting before the utility company receives the benefits. The normalization
25 rules say that the accelerated depreciation used in the Cost of Service calculation (for

current expense) must use the same method and life used in the rate base reduction so as not to have a mismatch of the benefits.

These rules were summarized by Staff witness Oligschlaeger in Case No. WO-2018-0373 (Exh. 3, Oligschlaeger Dir., p. 3):

> For rate purposes, the tax benefits associated with timing differences can either be assigned to ratepayers upfront by reducing the amount of income tax expense the utility would otherwise recover from its customers (i.e., the "flow-through" method of ratemaking for income taxes), or those benefits can be retained by the utility for a period of time before being passed on to ratepayers (the "normalization" method of ratemaking for income taxes).
>
> ***********
>
> For utility ratemaking, the concept of tax normalization is applied by collecting income tax expense amounts in rates calculated as if the particular tax deduction or treatment was not available to the utility.

Q. Do the normalization rules impact the Commission?

A. Yes. In most situations, while a state utility regulatory commission is aware of tax impacts, it would not be required to treat taxes in any particular manner from a ratemaking standpoint. However, as Staff witness Oligschlaeger stated in his testimony in Case No. WO-2018-0373 (Exh. 3, Oligschlaeger Dir., p. 3-4):

> . . . in regard to the specific timing differences associated with use of accelerated depreciation methods for tax purposes, the IRS Code effectively mandates that regulatory commissions normalize the benefits of the accelerated depreciation tax deductions in setting rates. If the regulatory commissions do not allow for such normalization treatment, that action could result in loss of the entire accelerated depreciation deduction by the utility.

Mr. Oligschlaeger went on to correctly comment that "[i]n essence, the tax normalization requirements of the IRS Code mandate that utility rates be set so that customers do not receive the tax benefit of accelerated depreciation deductions any faster than over the estimated straight-line book lives authorized for the utilities' assets."

1

2 **Q. Do the normalization rules have an impact on the calculation of MAWC's rate**
3 **base?**

4 A. Yes. This can be seen in prior IRS Private Letter Rulings ("PLR") that support
5 Company's position with respect to the impact on its NOLC DTA and its impact on
6 rate base. PLRs 201718015 and 201709008 concluded a formula cost of service rate
7 proceeding would be viewed as a separate rate case, for purposes of applying the tax
8 normalization rules. PLRs 201436037 and 201519021 are two of a number of rulings
9 that support the Company's calculation of the impact on NOLC DTA applying a "with
10 and without method" and including the resulting NOLC DTA in rate base. PLR
11 201548017 uses the term "last dollars deducted methodology" and is the same as the
12 "with and without method". The PLRs are included as **Schedule JRW-1** through **JRW-**
13 **5.**

14

15 **Q. Please describe the "with and without method".**

16 A. The with and without method refers to calculating the Company's taxable income or
17 loss with accelerated depreciation and without accelerated depreciation. If there is a
18 new or additional net operating loss (NOL) generated with accelerated depreciation,
19 then the NOL generated is clearly related to accelerated depreciation and needs to be
20 included in the deferred tax balance in rate base.

21

22 **Q. How would you summarize this information?**

23 A. Treasury Regulations *§ 1.167(l)- 1* seem to make it clear, the taxpayer in applying the
24 tax normalization rules should be concerned with a deduction subject to normalization

1 both causing a delay in the use of an existing NOLC, as well as building a new NOLC
2 in the current period. Lastly, the Company's methods in estimating and including the
3 NOLC DTA are both consistent with the tax normalization rules and the underlying
4 economics related to providing an incentive to incrementally invest in ISRS-eligible
5 property.
6
7 **Q. Is Section 393.1000, RSMo, consistent with the tax normalization rules you**
8 **referred to above?**
9 A. Yes, based on my understanding of the tax normalization rules, and my plain reading
10 of the applicable statutory guidance and Commission rule.
11
12 **Q. Is MAWC's inclusion of income tax expense and resulting ADIT balances**
13 **consistent with statutory guidance and tax normalization rules cited above with**
14 **respect to computing the revenue requirement that represents the ISRS**
15 **surcharge?**
16 A. Yes, based on my plain reading.
17
18 **IV. <u>MAWC ISRS CASE WO-2018-0373</u>**
19 **Q. Has the Commission previously addressed this issue?**
20 A. Yes. This was the primary issue presented to the Commission in Case No. WO-2018-
21 0373, which was decided on December 5, 2018.
22
23 **Q. How did the Commission rule?**

1 A. The Commission concluded that the Company had not presented evidence sufficient to
2 support that it will have a NOL in 2018. In support of its decision, the Commission
3 stated, among other things, that MAWC "will not generate a new NOL" to offset its
4 taxable income in 2018 and 2019. (WO-2018-0373 Report and Order, p. 8)
5
6 **Q. What is the status of Case No. WO-2018-0373?**
7 A. MAWC has an appeal of this case pending before the Missouri Court of Appeals,
8 Western District.
9
10 **Q. Why is this an important issue for MAWC?**
11 A. MAWC believes it is entitled to recover its weighted cost of capital pursuant to the
12 Missouri statutes, and should diligently protect itself and its customers against the
13 significant tax consequences of a tax normalization violation or violation of the terms
14 of a consent decree. These significant tax consequences can include the permanent loss
15 of the ability by MAWC to take advantage accelerated tax depreciation and/or the
16 permanent and temporary loss of tax benefits associated with having followed a more
17 liberal accounting method in claiming repairs for tax purposes.
18
19 **Q. Is there a method to address MAWC's concerns with respect to protecting itself**
20 **and its customers against a tax normalization violation or violation of its consent**
21 **decree?**
22 A. Yes. Soon after December 5, 2018, the date the Commission ruled in Case No. WO-
23 2018-0373, MAWC began the process of pursuing a Private Letter Ruling from the
24 Internal Revenue Service ("IRS"), while trying to keep avenues open for the

1 Commission to be able remediate any concerns validated by the IRS in the ruling
2 process.
3
4 ## V. PRIVATE LETTER RULING REQUEST

5 **Q. Has the Company requested a Private Letter Ruling ("PLR") from the IRS to**
6 **address its concerns?**

7 A. MAWC is in the final stage of doing so. That final stage is the process of working with
8 Staff to agree on the final content that should be included in the PLR request. The
9 Company expects to file before the end of this month, and hopefully within the next
10 several days.
11

12 **Q. What were the steps required before the Company could file the request for the**
13 **Private Letter Ruling?**

14 A. MAWC's process included the following steps:

15 • In December, the Company discussed filing the PLR with outside experts and
16 selected Deloitte to draft the PLR and advise us in executing the process;
17 • In December 2018 and January 2019, we drafted a pre-submission version of the
18 PLR request, and engaged the IRS in scheduling a pre-submission conference. We
19 also drafted the formal notice concerning the potential violation of the tax
20 normalization rules that occurred when the Commission ruled in December.
21 Unfortunately, the government shutdown that occurred during this time frame
22 caused delays in execution of these steps;
23 • On February 1, 2019, a letter was sent to the IRS notifying them of a potential
24 normalization violation;

1 • On March 19, 2019, American Water representatives, on behalf of MAWC,
2 participated in a pre-filing conference with the IRS in regard to the private letter
3 ruling matter; and,
4 • On April 16, 2019, MAWC provided the Missouri Public Service Commission
5 Staff a draft of the private letter ruling request for review and comment. This
6 interaction with the Commission is a required step before MAWC may file the
7 private letter ruling request. The Staff provided its content in the form of an
8 attachment to the ruling, as well as feedback to sections drafted by the Company,
9 on May 1, 2019. The Company is currently reviewing the draft PLR request in
10 light of the feedback provided by Staff. Thereafter, both the Company and Staff
11 will complete their respective final reviews and the Company will file the PLR.
12 The request itself will require payment of a $30,000 application fee to the IRS with
13 the filing. It is anticipated that it will take up to 6 months for the IRS to issue its
14 decision after the request has been filed.
15
16 VI. IMPACT ON MAWC AND ITS CUSTOMERS
17 **Q. What are the consequences of excluding the DTA that results from the NOLC**
18 **related to the ISRS-eligible investments from the rate base component of the ISRS**
19 **surcharge computation?**
20 A. As part of a normalized method of accounting, and consistent with the tax
21 normalization rules, the cumulative balance of plant-related deferred taxes is treated as
22 a "zero interest loan" from the government, and is a reduction to rate base. Including
23 the DTL related to claiming deductions on ISRS-eligible investment, without including
24 the DTA that results from those deductions, would cause the reduction to rate base to

1 be greater than the "zero interest loan" actually received from the government. Thus,
2 the surcharge would reflect the incremental ISRS-eligible investments being financed
3 with an interest free loan, when in fact those incremental expenditures are being
4 financed with debt and equity. I would not expect this result to be consistent with the
5 economic result the Commission and Missouri General Assembly intended by allowing
6 for an ISRS mechanism. This result is also inconsistent with the applicable tax
7 normalization rules, and inconsistent with the tax repairs IRS Consent Agreement
8 described below, which the Company is subject to and which requires a normalized
9 method of accounting be used for tax repairs.
10
11 **Q. If the IRS determines the Company violated the normalization rules, what are the**
12 **consequences?**
13 A. As suggested above, the consequences depend on the Company's ability to work with
14 the Commission to cure the violation. If the Company has the ability to collect the
15 revenue from customers that should have been collected in those periods where the
16 violation occurred, then there should be no adverse consequences. If the Company is
17 unable to cure the violation, in other words, has no mechanism to appeal the decision
18 and be made whole for these revenues, for example either through a Commission
19 rehearing or as a result of an appellate proceeding, then the Company could lose the
20 ability to use accelerated depreciation in the future.
21
22 **Q. If the Company loses accelerated depreciation due to an uncurable normalization**
23 **violation, is that change permanent?**
24 A. Yes. The only cure that I am aware of is for a Federal legislative exception to be made.

1

2 **Q. Is there an example of a public utility that has ever lost the ability to use**
3 **accelerated depreciation due to a normalization violation?**

4 A. I am aware of a situation where two utilities but for an act of Congress would have lost
5 accelerated depreciation. In California in the late 1970s the California Public Utility
6 Commission ("CPUC") and two phone utilities had a dispute regarding normalization.
7 These companies were Pacific Telephone and Telegraph ("PT&T") and General
8 Telephone and Electronics Corporation ("GTE"). In short as I understand it, orders
9 were entered by the CPUC requiring refunds and rate reductions. PT&T and GTE
10 exhausted all legal remedies available and the orders became final. At that point the
11 IRS issued deficiency notices because they had ruled in PLRs that if the orders became
12 final the orders were inconsistent with normalization. The whole situation prompted
13 the congress to enact within the Highway Revenue Act of 1982, what is now known as
14 the consistency provisions related to normalization. In addition, the law provided
15 special transitional guidance which effectively relieved these two companies from the
16 violation. Qualified CPUC Orders were exempted and not considered inconsistent with
17 normalization subject to certain conditions. Specifically, the definition of Qualified
18 CPUC Order limited the guidance to the two specific companies involved. Further
19 other requirements were imposed as follows:

20 • A closing agreement had to be entered into with the IRS within certain dates as
21 prescribed.

22 • Payment of tax equal to the amount actually flowed through under the qualified
23 order.

24

1 **Q. What would the impact be to customers if the Company was no longer able to use**
2 **accelerated depreciation or take the repairs deduction?**
3 A. It would result in higher rates for customers. Both the repairs deduction and accelerated
4 depreciation allow the Company to expense investments faster for tax purposes than
5 for book purposes. This differential, previously described as a "zero interest loan" from
6 the government, is a reduction to rate base. All else being equal, both the Company's
7 revenue requirement and the customer's rates are lower when the Company can utilize
8 this tax treatment.
9
10 **VII. STAFF RECOMMENDATION**
11 **Q. What explanation has the Staff provided for its removal of the Deferred Tax Asset**
12 **("DTA") created by MAWC's ISRS-related NOL from rate base ?**
13 A. . Staff claims "no amount of net operating loss ("NOL") has actually been generated
14 for income tax purposes by MAWC on an aggregate basis since October 1, 2018,"[1] and
15 that "Staff has not been presented with any evidence that imputation of a 'hypothetical'
16 NOL amount into ISRS rate base this case is required to comply with the normalization
17 provisions of the Internal Revenue Service Code." [2]
18
19 **Q. Do you agree with Staff's recommendation to exclude the DTA from the revenue**
20 **requirement calculation?**
21 A. No, I do not. "Recognition of accumulated deferred income taxes" requires recognition
22 of both the Deferred Income Tax liabilities and the Deferred Income Tax assets.

[1] Case No. WO-2019-0184, Staff Memorandum, page 4.
[2] Case No. WO-2019-0184. Staff Memorandum, page 4.

1

2 **Q. How do you respond to the Staff's suggestion that MAWC has imputed a**
3 **"hypothetical" DTA?**

4 A. The Company's Application provides a calculation that computes the expected
5 incremental effect that ISRS-eligible investments will have on taxable income or loss,
6 and the incremental effect that ISRS-eligible investments will have on Deferred Income
7 Tax Balances, including the incremental effect that making ISRS-eligible investments
8 will have on the Company's Net Operating Loss Carryover ("NOLC") balance. While
9 based on actual plant expenditures, all of the book to tax temporary timing differences
10 the company provided in its Application are estimates and as such are somewhat
11 hypothetical in nature as they would be in a rate proceeding where tax estimates are
12 provided in advance of a return being filed. Staff only attributes the term
13 "hypothetical" to the NOL DTA that they suggest should be excluded from the ISRS
14 rate base, yet this is no more or less an estimate and "hypothetical" than the DTL
15 generated in claiming tax depreciation and tax repairs. The Company's position is the
16 incremental ISRS-eligible investments would generate tax deductions in excess of
17 income generated, so on an incremental basis would generate a tax loss. The update
18 to the calculation provided in the Company's Application can be found on page 2 of
19 Schedule BWL-2, attached to the Direct Testimony of Company witness Brian
20 LaGrand.

21

22 **Q. Will a NOL always result under that calculation method whether MAWC is**
23 **actually recording an NOL on its books or not?**

1 A. No. You have to be in an Net Operating Loss Carryover (NOLC) position of an
2 amount greater than the ISRS deductions in order for that to occur on a with and
3 without basis as required by the IRS.
4
5 **Q. What is a taxable net operating loss (NOL)?**
6 A. A NOL results when costs deductible for tax purposes during the relevant period exceed
7 income recognized for tax purposes during the same period.
8
9 **Q. What is a net operating loss carryover ("NOLC") and how does it differ from a**
10 **NOL?**
11 A. A NOLC is a balance of NOL's at the end of a period that is being carried forward by
12 a taxpayer. A NOLC is used as it reduces taxable income in a future period.
13
14 **Q. How is a NOLC accounted for?**
15 A. A NOLC is represented by a Deferred Tax Asset (DTA) that is a part of the
16 Accumulated Deferred Income Tax amount reflected on the Company's balance sheet
17 and, for regulated utilities, reflected in rate base.
18
19 **Q. Is MAWC in the position of being in a federal NOLC?**
20 A. Yes, the table below shows NOLC and respective DTA as the end of each year
21 beginning with 2017.

Tax Year	MAWC NOLC	DTA - MAWC NOLC (@21%)
2017	162,980,275	34,225,858
2018	105,268,926	22,106,474
2019	43,530,256	9,141,354

Q. Do the eligible ISRS investments in this case generate costs deductible for tax purposes in excess of the taxable income they generate during the relevant period?

A. Yes, the eligible ISRS investments in this case generate NOL of $34.4 million for the period ending 05/30/2019.

Q. What issues are created by Staff's approach?

A. The removal of the NOLC DTA is inconsistent with the Missouri ISRS statutes as they would allow the Company to recover its weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements that are included in a currently effective ISRS. Of equal concern to the Company is that the removal of the NOLC DTA is inconsistent with the tax normalization rules as outlined in the Internal Revenue Code, and is inconsistent with a normalized method of accounting that the Company and the IRS agreed would be used to for tax repairs in a consent decree.

VIII. CONSENT AGREEMENT

Q. Please explain the Consent Agreement the Company entered into with the IRS.

1 A. In 2010, the Company entered into a consent agreement with the IRS which authorized
2 the Company's requested Change in Accounting Method to allow the utilization of the
3 repairs deduction/method. As, I understand it if the Company did not agree to the
4 terms, then it would not have been allowed the additional repairs deductions on its tax
5 returns. A copy of the Consent Agreement is included as **Schedule JRW-6**.
6
7 **Q. What is the "repairs" deduction from a tax perspective?**
8 A. In 2008, proposed IRS regulations were issued that allowed for more tax deductions
9 related to repairs as opposed to book deductions. Previous to this, the Company's tax
10 deduction was the same as the book deduction. Companies were required to file for
11 approval of the tax method change. In 2013, the final IRS regulations were issued and
12 over the years some specific industry guidance has been issued, but not for the Water
13 or Gas industries. Basically the IRC allows, based on certain criteria in IRC 162(a), to
14 expense for tax purposes items that are capitalized for book purposes, so long as the
15 expenditure does not prolong the useful life of the property, convert it to another use,
16 expand the capacity to provide water to customers or in any way improve the property.
17 The expenditure basically needs to be a repair or replacement of property to keep it in
18 good working order.
19
20 **Q. Does the Company have any requirements that must be fulfilled in order to utilize**
21 **the repairs deduction?**
22 A. Among others, the Company must utilize a Normalized method of accounting for all
23 public utility property for which as repairs deduction was taken on a tax return. While
24 a tax repairs deduction is it is not specifically subject to that the tax normalization rules

1 as describe in the Internal Revenue Code (IRC) as associated treasury regulation, the
2 consent decree agreement is still binding to the Company until further notice from the
3 IRS and therefore the Company must follow a normalized method of accounting as
4 referenced to the IRC in the consent decree as it relates to its repairs deductions.
5

6 **IX. NET OPERATING LOSS CARRYOVER ("NOLC")**

7 **Q. What is the Company's NOLC Balance before addressing the incremental effects**
8 **of making the ISRS-eligible investments for 2018?**

9 A. The Company had a NOLC balance of $105.3 million as of 12/31/2018, and the
10 American Water Consolidated Group that the Company files as part of had a NOLC
11 balance of $706.8 million as of 12/31/2018.
12

13 **Q. Do the incremental ISRS-eligible investments during the measurement period**
14 **generate taxable income or loss?**

15 A. Yes. The incremental ISRS-eligible investments are estimated to generate a taxable
16 loss of $34.4 million during the measurement period for this case. This is composed
17 of a pre-tax loss of $0.8 million from the current ISRS, taxable income of $2.9 million
18 from the prior ISRS, and tax repair deductions and tax depreciation adjustments of
19 $36.5 million. Please see page 2 of Schedule BWL-2, attached to the Direct Testimony
20 of Company witness Brian LaGrand.
21

22 **Q. Does the incremental ISRS-eligible investment during the measurement period**
23 **either increase or delay the use of the Company's NOLC on a with and without**
24 **basis?**

1 A. Yes. Viewed incrementally using the with and without method outlined in various
2 PLRs issued by the IRS, the incremental ISRS-eligible investment increases and delays
3 the use of the Company's NOLC to a future period. The Company and the
4 Consolidated Group both were carrying a NOLC balance of $105.3 million and $706.8
5 million respectively as of December 31, 2018, and based on projections would estimate
6 to carry a NOLC balance of $43.5 million and $298.9 million respectively at December
7 31, 2019, based on being included in the American Water Consolidated group. These
8 projections include the ISRS investments. Without including these ISRS investments,
9 the Company and the Consolidated group would have been able to utilize more NOL
10 and would have a projected NOLC for 2018 of $98.3 million and $661.1 million
11 respectively.
12
13 **X. OTHER PRIVATE LETTER RULINGS**
14 **Q. Do the PLRs listed above outline the relevant sections of the tax code and**
15 **regulation and support the Company's position in this matter?**
16 A. Yes, in the PLRs, such as in PLR 201548017, the IRS representative acknowledges the
17 lack of guidance and addresses it as follows:
18 *Section 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be*
19 *taken into account for normalization purposes. Further, while that section*
20 *provides no specific mandate on methods, it does provide that the Service has*
21 *discretion to determine whether a particular method satisfies the normalization*
22 *requirements. Section 1.167(l)-(h)(6)(i) provides that a taxpayer does not use*
23 *a normalization method of regulated accounting if, for ratemaking purposes,*
24 *the amount of the reserve for deferred taxes which is excluded from the base to*

1 *which the taxpayer's rate of return is applied, or which is treated as no-cost*
2 *capital in those rate cases in which the rate of return is based upon the cost of*
3 *capital, exceeds the amount of such reserve for deferred taxes for the period*
4 *used in determining the taxpayer's expense in computing cost of service in such*
5 *ratemaking. Because the ADIT account, the reserve account for deferred taxes,*
6 *reduces rate base, it is clear that the portion of an NOLC that is attributable to*
7 *accelerated depreciation must be taken into account in calculating the amount*
8 *of the reserve for deferred taxes (ADIT).*

9 The above makes it clear that at least the amount of the NOL Carryforward attributable
10 to accelerated depreciation should be included as an increase to rate base to offset the
11 decrease from accelerated depreciation.

12

13 **Q. Does the PLR provide guidance as to determine how much of the NOL relates to**
14 **accelerated depreciation?**

15 A. In order to avoid a normalization violation, to determine how much of the ADIT asset
16 related to depreciation the IRS states in PLR 201548017:

17 *The "last dollars deducted" methodology employed by Taxpayer is specifically*
18 *designed to ensure that the portion of the NOLC attributable to accelerated*
19 *depreciation is correctly taken into account by maximizing the amount of the*
20 *NOLC attributable to accelerated depreciation. This methodology provides*
21 *certainty and prevents the possibility of "flow through" of the benefits of*
22 *accelerated depreciation to ratepayers. Under these facts, any method other*
23 *than the "last dollars deducted" method would not provide the same level of*
24 *certainty and therefore the use of any other methodology is inconsistent with*

1 *the normalization rules*

2

3 **Q. How does the IRS state the above in the "Holdings" section of the ruling?**

4 A. The IRS states in PLR 201548017:

5 *Under the circumstances described above, the reduction of Taxpayer's rate*
6 *base by the balance of its ADIT accounts unreduced by its NOLC-related*
7 *deferred tax account would be inconsistent with the requirements of § 168(i)(9)*
8 *and § 1.167(l)- 1 of the Income Tax regulations. 2. Under the circumstances*
9 *described above, the reduction of Taxpayer's rate base by the full amount of its*
10 *ADIT account balances offset by a portion of its NOLC related account balance*
11 *that is less than the amount attributable to accelerated depreciation computed*
12 *on a "last dollars deducted" basis would be inconsistent with the requirements*
13 *of § 168(i)(9) and § 1.167(l)-1. 3. Under the circumstances described above,*
14 *any reduction in Taxpayer's tax expense element of cost of service to reflect the*
15 *tax benefit of its NOLC would be inconsistent with the requirements of §*
16 *168(i)(9) and § 1.167(l)-1.*

17

18 **Q. Please summarize these statements.**

19 A. Including a reduction to rate base for ADIT liabilities related to accelerated
20 depreciation without reducing that amount by the ADIT asset related to the NOL caused
21 by the accelerated depreciation would cause a normalization violation. Further to
22 determine the amount of the ADIT asset to include as a reduction to the ADIT liability
23 would have to be done on a "last dollar deducted method" or in other rulings a with and
24 without method. Any other method would cause a normalization violation. Finally any

1 reduction to tax expense below the normalized tax expense would cause a
2 normalization violation.
3
4 **Q. The IRS rulings provide a method of determining how much of the NOLC DTA**
5 **should be included as an offset to the DTL for depreciation. Should MAWC**
6 **include only that portion of the NOL DTA?**
7 A. MAWC should include the entire amount of the NOLC DTA. It is my opinion that
8 without regard to the above regulations or PLRs, the entire NOLC DTA that is caused
9 by any cost included in a given regulatory proceeding should be included as an addition
10 to rate base. Not including the portion of the DTA related to tax repairs would be
11 inconsistent with a normalized method of accounting required in the Company's
12 consent agreement with the IRS. The NOLC DTA is indicative not yet having gotten
13 the cash from the IRS related to tax deduction claimed, thus removing the NOLC DTA
14 before the cash received would imply there is a zero interest loan balance, that is
15 actually being financed with debt and equity depriving the company of recovering those
16 ISRS-related costs.
17
18 **Q. Does this conclude your direct testimony?**
19 A. Yes, it does.

IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201548017 (Aug. 19, 2015), Internal Revenue Service, (Aug. 19, 2015)

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LTR 201548017, August 19, 2015

Symbol: CC:PSI:B06-PLR-116998-15

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated May 14, 2015, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is primarily engaged in the regulated distribution of natural gas in State A. It is incorporated in State B and is wholly owned by Parent. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer incurred net operating losses (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission offsets rate base by Taxpayer's ADIT balance. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission was, if Commission allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then an offsetting reduction should be made to Taxpayer's income tax expense element of service.

A Utility Law Judge upheld Taxpayer's position with respect to the NOLC-related ADIT and ordered Taxpayer to seek a ruling from the Internal Revenue Service on this matter. This request is in response to that order.

Taxpayer requests that we rule as follows:

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1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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) of the Code provides that one way the requirements of section 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 section 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 section 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.

Former section 167(l) of the Code 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations 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 section 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(1)-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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's

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reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-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, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except 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. That section also notes 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(1)-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 1.167(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 section 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(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 subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion 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 the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the proposed order by the Utility Law Judge upholding Taxpayer's position that

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the NOLC-related deferred tax account must be included in the calculation of Taxpayer's ADIT is in accord with the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. In addition, such adjustment would be made specifically to mitigate the effect of the normalization rules in the calculation of Taxpayer's NOLC-related ADIT. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). This "offsetting reduction" would violate the normalization provisions.

Based on the representations submitted by Taxpayer, we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

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, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of Associate Chief Counsel (Passthroughs & Special Industries).

cc: *****

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IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201718015 (Feb. 07, 2017), Internal Revenue Service, (Feb. 7, 2017)

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Symbol: CC:PSI:B06-PLR-125020-16

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated August 11, 2016, submitted by Parent on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer, a single member limited liability company, engaged in the transmission of electricity and operates a high voltage system in States A, B, C, and D that transmits electricity from generating stations to local distribution facilities connected to its system. Taxpayer is also an independent transmission utility subject to regulation by Commission with respect to terms and conditions of services, including the rates it may charge for its services.

Taxpayer transmission rates are set annually using a Commission-approved formula rate. The formula uses a cost-of-service model. On Date 1 of each year, Taxpayer estimates its revenue requirement for the following calendar year, the service year, based in part on the facilities in service at that time and those expected to be placed in service during that year. This estimate of Taxpayer's revenue requirement, a true-up from a given year (discussed below), and a Commission-approved rate of return are entered into the template for the formula to calculate the rates. The rates for that calendar year are determined under the Commission-approved formula and go into effect on Date 2 of the following calendar year with no additional action by Commission, although the rate is subject to legal challenge at the Commission.

The Commission-approved formula rate template contains a "true-up" mechanism under which the Taxpayer compares its actual revenue requirement to its actually-billed revenues for the service year. The actual net revenue requirement for a service year is determined after the end of the service year based on operating costs and capital cost actually incurred during the service year. The actual net revenue requirement for the service year and, accordingly, the true-up amount computed in the year following the service year are based largely on the amounts reported in the annual Commission Form for the service year. The billed revenues for such service year are based on the projected revenue requirements and rates estimated prior to the service year and the amount of network load on the transmission systems and transmission services provided by Taxpayer during the service year. If billed revenue is greater than the actual revenue requirement for the service year the over-collection is refunded in customer bills within two years of the service year; if billed revenue is less than the actual revenue requirement for the service year the under-collection is collected two years after the service year. For both under and over collections, a carrying charge equivalent to Commission's standard refund interest rate is imposed. The over- or under-collection typically results from differences between the projected revenue requirement used to establish the billing rate and actual revenue requirement or from differences between actual and projected monthly peak loads.

On Date 3, Taxpayer posted its projected revenue requirement for the Year 3 service year based on, among other estimates, plant additions for Year 3, book and tax depreciation for Year 3, current and deferred tax expense for Year 3 and the deferred tax reserve as of the end of Year 3. Taxpayer estimated its tax depreciation,

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deferred tax reserve and current and deferred tax expense based on its intention to elect out of the additional first year depreciation deduction on its Year 3 tax return.

On December 19, 2014, the Tax Increase Prevention Act of 2014 (P.L. 113-295) was enacted and amended § 168(k) to extend the 50 percent additional first year depreciation deduction on qualified property placed in service before January 1, 2015, and, for property described in § 168(k)(2)(B) or (C), placed in service before January 1, 2016. Parent paid estimated federal income taxes for Year 3, based on its intention to not deduct the additional first year depreciation on any of its qualified property placed in service during Year 3. On December 18, 2015, §§ 143(a)(1) and 143(b)(1) of the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) further amended § 168(k) to extend the 50 percent additional first year depreciation deduction on qualified property placed in service before January 1, 2016, and for property described in § 168(k)(2)(B) or (C), placed in service before January 1, 2017.

On Date 5, Customer submitted a formal challenge to Commission with respect to certain inputs of Taxpayer's formula rates. Specifically, Customer challenged the amounts of accumulated deferred federal income taxes (ADFIT) used to calculate charges for transmission services over Taxpayer's facilities and alleged that Taxpayer unreasonably and imprudently opted out of using the additional first year depreciation for calculation of its federal income tax expense, thereby understating the ADFIT amounts and unduly increasing the transmission charges that Customer must pay for transmission service, adversely affecting consumers served by Customer.

On Date 7, Parent made its Year 3 extension payment to the Service taking into account its first quarter Year 4 estimated tax payment. Because Parent had not yet determined that it would elect to not deduct the additional first year depreciation for Year 3 or Year 4, Parent did not reduce its Year 3 extension payment or its first quarter Year 4 estimated tax payment for any overpayment of its Year 3 estimated taxes. On Date 8, Taxpayer made an intercompany tax payment to Parent related to the Year 3 extension and the Year 4 first quarter estimate that reflected its intention to elect to not deduct the additional first year depreciation for Year 3 or Year 4. Because Taxpayer also had not yet determined that it would elect to not deduct additional first year depreciation for Year 3 or Year 4, Taxpayer did not reduce this intercompany tax payment for any overpayment of Year 3 estimated taxes.

On Date 7, Commission granted in part and denied in part the formal challenge filed on Date 5 by Customer, and found that Taxpayer had not demonstrated that its decision, through its corporate parent to opt out of using the additional first year depreciation for calculation of its federal income tax expense was prudent. Commission required Taxpayer to recalculate its transmission revenue requirements, effective Date 4, to simulate the taking of additional first year depreciation for eligible facilities in Year 3. However, Commission declined to require Taxpayer to simulate the taking of additional first year depreciation in the calculation of its transmission revenue requirement for years prior to Year 3 for which Taxpayer elected not to deduct the additional first year depreciation because imputing additional first year depreciation in the calculation of Taxpayer's revenue requirements for such years "may pose a risk of a normalization violation." For the Year 3 service period, Commission Decision 1 stated "[t]o the extent that [Taxpayer] believes that our requiring it to simulate the taking of bonus depreciation would create the possibility of a normalization violation, [Parent] (and therefore [Taxpayer] has the ability to avoid this violation by filing a tax return for [Year 3]) without opting out of bonus depreciation."

On Date 9, after analysis of Commission Decision 1, Taxpayer's management determined that it would deduct the additional first year depreciation on its Year 3 and Year 4 tax returns.

On Date 10, Taxpayer requested a rehearing at Commission, arguing that Commission has no authority to negate the statutory right of a taxpayer to opt out of deducting the additional first year depreciation by declaring such an election imprudent and that Commission lacks the authority to require Taxpayer to simulate the taking of the additional first year depreciation in setting its rates. Taxpayer also requested Commission should not apply the ratemaking effects of the Year 4 decision to deduct the additional first year depreciation retroactively to Date 4, as provided in Commission Decision 1. On Date 10, Taxpayer filed its Commission Form for the Year 3 service year with its ADFIT computed in a manner consistent with its intention as of Date 6, to not deduct the additional first year depreciation on its Year 3 tax return.

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Taxpayer did not have an ability to reduce its first three quarterly Year 4 estimated tax payments for the anticipated overpayment of Year 3 estimated taxes because Parent and Taxpayer expect to incur net operating losses (NOLs) in Year 4 and, thus, Parent did not make estimated tax payments and Taxpayer did not make tax-sharing payments to Parent for these quarters.

On Date 11, Taxpayer posted its Year 3 formula rate true-up computing an actual Year 3 revenue requirement for purposes of determining the Year 3 true-up to be refunded in Year 5 with interest accruing beginning in Year 3. The computation of deferred taxes in the actual Year 3 revenue requirement, as provided in Commission Decision 1, reflected Taxpayer's decision in Year 4 to deduct the additional first year depreciation for Year 3. Because this Year 4 decision was not reflected in Taxpayer's Commission Form for Year 3, adjustments were required to the reported ADFIT balances as of Date 6, in order to reflect the deduction of the additional first year depreciation for Year 3, pursuant to Commission Decision 1.

On Date 13, Parent filed its Year 3 consolidated federal income tax return. Parent reported a consolidated NOL and Taxpayer deducted the additional first year depreciation resulting in a NOL on a stand-alone basis. On Date 16, Parent received a refund from the Service of its Year 3 estimated federal income taxes paid and on Date 18, Parent made an inter-company tax-sharing payment to Taxpayer related to the refund of Year 3 estimated federal income taxes.

On Date 14, Parent filed Forms 1139 (Corporation Application for Tentative Refund) to carry back its Year 3 NOL to its Year 1 and Year 2 tax years. On Date 17, Parent received the refund from the Internal Revenue Service resulting from the carryback of its Year 3 consolidated NOL to Year 1 and on Date 18, Parent made an inter-company tax-sharing payment to Taxpayer related to the refund of Year 1 NOL carryback.

On Date 12, Commission issued Commission Decision 2 denying rehearing and reconsideration that was requested by Taxpayer on Date 10. On Date 15, Taxpayer filed a petition to appeal Commission Decision 1 and Commission Decision 2 related to the Year 3 actual revenue requirement and true-up adjustment with the Court (the Appeal). The Appeal keeps the rate proceeding open procedurally and allows Commission to consider amending Commission Decision 1 and Commission Decision 2 and setting rates in a manner that complies with the normalization requirements, in the event the Service finds that the ratemaking prescribed by Commission Decision 1 and Commission Decision 2 would violate the normalization requirements if finalized and implemented. Taxpayer and Customer subsequently filed various motions and responses with the Court. On Date 19, the Court granted Taxpayer's motion to hold the appeals in abeyance.

Commission at all times has required that all public utilities under its jurisdiction use normalized methods of accounting.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above whereby the Commission orders a change in a management decision to elect not to deduct the additional first year depreciation for Year 3 and management decides, in Year 4, to deduct the additional first year depreciation on its Year 3 tax return, reflecting a reserve for accumulated federal income taxes (ADFIT) for the book/tax difference attributable to the additional first year depreciation deducted in Year 3 in the calculation of its Year 3 actual revenue requirement would violate the normalization requirements because that depreciation deduction did not result in the deferral of any taxes by the end of Year 3.

2. Whether, under the circumstances described above, adjusting Taxpayer's reserve for ADFIT for purposes of the true-up of Year 3, effective for rates in Year 5 and in its regulatory books of account to reflect additional first year depreciation deductions taken in its tax return for Year 3 would comply with the normalization requirements.

3. If, under the circumstances described above, the Service considers Taxpayer's ratemaking practice to violate the normalization requirements, when would Taxpayer's loss of the right to accelerated tax depreciation due to such violation begin.

LAW AND ANALYSIS

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Section 168(f)(2) of the 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. Section 168(i)(9)(C) provides that in the case of any public utility property to which § 168 does not apply by reason of § 168(f)(2), the allowance for depreciation under § 167(a) shall be an amount computed using the method and period referred to in § 168(i)(9)(A)(i).

Section 168(i)(10) provides, in part, that the term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of electrical energy 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, by any agency or instrumentality of the United States, or by a public service or public utility Commission or other similar body of any State or political subdivision thereof.

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.

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.

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). 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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover (NOLC) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

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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, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except 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. That section also notes 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 § 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 § 167(a).

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 subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion 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 the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

As described above, there are two ratemakings with respect to Taxpayer in the years under consideration. In the first, Taxpayer estimates its revenue requirement and in the second, there is a true-up which compares its actual revenue requirement to its actually-billed revenues for the service year. Whether, under these facts, the true-up ratemaking violates the normalization rules is the matter at issue here. Taxpayer based its estimates for the first ratemaking on its intention to elect to not claim the additional first year depreciation on its Year 3 tax return. However, Taxpayer's management decided to claim the additional first year depreciation following Commission's order to do so. On Taxpayer's Year 3 tax return, it claimed the additional first year depreciation. Thus, the rates that were determined (in part) by the true-up and went into effect in Year 5, were based on the actual taxes claimed by the Taxpayer on its Year 3 return and not on the estimates that were used by Taxpayer to determine those rates in effect during Year 3. Thus, Taxpayer's ADFIT was also adjusted for purposes of the true-up appropriately by reference to the Taxpayer's actual Year 3 tax liability and the amount of Federal taxes deferred by reason of the use of the additional first year depreciation.

Taxpayer has argued that there is a violation of the consistency rule set forth in § 168(i)(9)(B). We view the initial ratemaking and the true-up as distinct ratemakings. There is no requirement of consistency between separate ratemakings, even where one (here the true-up) seeks to correct the outcome of the other. Taxpayer changed its decision regarding the additional first year depreciation (under an order by Commission) from its initial intent to elect out of the additional first year depreciation deduction under which it made the estimates in

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the first ratemaking to its decision to claim the additional first year depreciation on its Year 3 return under which the true-up was calculated. In fact, Taxpayer chose to take the additional first year depreciation and actually took the additional first year depreciation on its Year 3 tax return. There was no simulation in the true-up but rather a reflection of the choice by Taxpayer to claim the additional first year depreciation. Thus, there is no consistency rule violation in the calculation of the true-up described above. Further, we do not believe that the decision by Commission results in Taxpayer's tax reserve exceeding the maximum allowable amount as described in § 1.167(l)-1(h) for the true-up.

Regarding the third issue, because in the circumstances described above, Taxpayer's true-up ratemaking complies with the normalization requirements, the issue of the timing of the tax effects of a normalization violation is moot.

Accordingly, we rule as follows:

1. Under the circumstances described above whereby the Commission orders a change in a management decision to elect not to deduct the additional first year depreciation for Year 3 and management decides, in Year 4, to deduct the additional first year depreciation on its Year 3 tax return, reflecting a reserve for accumulated federal income taxes (ADFIT) for the book/tax difference attributable to the additional first year depreciation deducted in Year 3 in the calculation of its Year 3 actual revenue requirement would not violate the normalization requirements because that depreciation deduction did not result in the deferral of any taxes by the end of Year 3.

2. Under the circumstances described above, adjusting Taxpayer's reserve for ADFIT for purposes of the true-up of Year 3, effective for rates effective in Year 5 and in its regulatory books of account to reflect additional first year depreciation deductions taken in its tax return for Year 3 would comply with the normalization requirements.

3. This issue is moot as discussed above.

While the taxpayer also requested a change in method of accounting ruling for the change in computing depreciation as a result of a normalization violation, this issue is moot because we have concluded that there is not any normalization violation.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In addition, we express no opinion regarding whether the Commission has the authority, as expressed in Commission Decision 1 and Commission Decision 2, to order Taxpayer to claim the additional first year depreciation on its tax return, rather than to elect out of the additional first year depreciation deduction. Further, no opinion is expressed or implied on whether any of the property for which Taxpayer claimed the additional first year depreciation is qualified property as defined in § 168(k).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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 representatives. 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).

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IRS Letter Rulings and TAMS (Current), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201709008 (Dec. 02, 2016), Internal Revenue Service, (Dec. 2, 2016)

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LTR 201709008, December 02, 2016

Symbol: CC:PSI:B06-PLR-119381-16

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated June 15, 2016, submitted by Parent on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is an integrated electric utility headquartered in State. Taxpayer is a wholly owned subsidiary of Parent and is included in Parent's consolidated federal income tax return. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer's business includes retail electric utility operations regulated within State by Commission A and Taxpayer is subject to the regulatory jurisdiction of Commission B with respect to terms and conditions of its wholesale electric transmission service and as to the rates it may charge for the provision of such services. Taxpayer's rates are established on a cost of service basis.

On Date 1, Taxpayer filed a rate case application (Case) with Commission B requesting authorization to change from charging stated rates for wholesale electric transmission service to a formula rate mechanism pursuant to which rates for wholesale transmission service are calculated annually in accordance with an approved formula. The proposed formula consisted of updating cost of service components, including investment in plant and operating expenses, based on information contained in Taxpayer's annual financial report filed with Commission B, as well as including projected transmission capital projects to be placed into service in the following year. The projections included are subject to true-up in the following year's formula rate.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. Taxpayer incurred a net operating loss (NOL) in each of Year 1 through Year 2 due to Taxpayer's claiming bonus depreciation, producing a net operating loss carryover (NOLC).

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" – that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of a NOLC.

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In the setting of utility rates by Commission B, a utility's rate base is offset by its ADIT balance. In its rate case filing, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules.

On Date 2, Commission B issued an order accepting Taxpayer's revisions to its rates. On Date 3, new rates went into effect, subject to refund. Several intervenors submitted challenges to the rate case and on Date 4, Taxpayer and those intervenors entered into a Settlement Agreement, which was filed with Commission B. On Date 5, Commission B issued an order accepting the Settlement Agreement, which allows for the inclusion of the ADIT related to the NOLC asset in rate base.

Commission B further stated in the order that it is the intent of Commission B that Taxpayer comply with the normalization method of accounting and tax normalization regulations. The order also requires Taxpayer to seek a private letter ruling (PLR) from the Service regarding Taxpayer's treatment of the ADIT related to the NOLC asset. Commission B also noted that after the Service issues a PLR, Taxpayer shall adjust, to the extent necessary, its ratemaking treatment of the ADIT related to the NOLC asset prospectively from the date of the PLR.

Taxpayer requests that we rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the 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.

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.

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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). 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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

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, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except 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. That section also notes 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 § 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 § 167(a).

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 subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion 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 the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and

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ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the order by Commission to include in rate base the ADIT asset resulting from the NOLC, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation is in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with or without" method would not provide the same level of certainty and therefore the use of any other methodology in computing the portion of the ADIT asset attributable to accelerated depreciation is inconsistent with the normalization rules.

We rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

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).

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IRS Letter Rulings and TAMS (Current), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201436037 (May. 22, 2014), Internal Revenue Service, (May 22, 2014)

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LTR 201436037, May 22, 2014

Symbol: CC:PSI:B06-PLR-148310-13

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" — that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case included six months of forecast data, which the Taxpayer updated with actual data in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission B was, if Commission B allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then Taxpayer's income tax expense element of service should be reduced by that same amount.

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Commission B, in an order issued on Date C, allowed Taxpayer to reduce ADIT by the amount that Taxpayer calculates did not actually defer tax due to the presence of the NOLC and ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date C.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional quarter. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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) of the Code provides that one way the requirements of section 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 section 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 section 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.

Former section 167(l) of the Code 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations 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 section 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

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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(1)-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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-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, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except 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. That section also notes 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(1)-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 1.167(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 section 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(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 subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion 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 the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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

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service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied 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. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

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

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this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: *****

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IRS Letter Rulings and TAMs (1998-2017), UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201519021 (Feb. 04, 2015), Internal Revenue Service, (Feb. 4, 2015)

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LTR 201519021, February 04, 2015

Symbol: CC:PSI:B06-PLR-136851-14

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated October 1, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying natural gas service in State A. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of service. Taxpayer's rates are established on a cost of service basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year D. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in each of Year B, Year C, and Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year C and Year D, the beginning and end of the test period.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

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In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission also held that to the extent tax normalization rules require including the NOL in rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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) of the Code provides that one way the requirements of section 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 section 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 section 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.

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Former section 167(l) of the Code 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations 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 section 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. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

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, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except 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. That section also notes 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 1.167(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 section 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 subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion 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 the future portion of the period.

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Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting 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. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes 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. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission is not in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

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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, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

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AMERICAN WATER

September 10, 2010

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:B01- Innessa Glazman
1111 Constitution Avenue, N.W., Room 5336
Washington, DC 20224

RECEIVED
INTERNAL REVENUE SERVICE
2010 SEP 13 PM 12: 31

RE: American Water Works Company, Inc. & Subs.
EIN: 51-0063696
CAM-108421-09
CONSENT AGREEMENT

Dear Ms. Glazman:

This letter relates to a Form 3115, Application for Change in Accounting Method, filed by the above-mentioned Taxpayer on behalf of itself and various subsidiaries, requesting permission to change their method of accounting for (1) costs to repair and maintain tangible property, and (2) dispositions of certain tangible depreciable property, for the taxable year that ended December 31, 2008.

Please find enclosed a Consent Agreement dated July 30, 2010, and signed by the Taxpayer on September 10, 2010. However, we note that the EINs for two of the entities subject to the Form 3115 and enclosed Consent Agreement, American Water Engineering, Inc., and United Water Virginia, Inc., were incorrectly reflected in Appendix A to the Consent Agreement. In its information response to the IRS, by letter dated July 1, 2009, the Taxpayer provided the correct EINs of the two entities, American Water Engineering, Inc. (EIN: 76-0654501), and United Water Virginia, Inc. (EIN: 54-1016694). The Taxpayer will be effecting the change permitted in the Consent Agreement.

If you have any questions, please call the Taxpayer's authorized representative, Robert Weiss, at 202-414-1421.

Sincerely,

Mark Chesla
Vice President and Controller

Enclosures
Executed Consent Agreement

INTERNAL REVENUE
2010 SEP 13 PM

CONSENT AGREEMENT

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

American Water Works Company, Inc.
and Subs.
P.O. Box 5600
Cherry Hill, NJ 08003

Attn: Mark N. Chesla
VP and Controller

EIN: 51-0063696

Person to Contact:
Innessa Glazman
Telephone Number:
(202) 622-7327
Refer Reply to:
CC:ITA:B01 CAM-108421-09
Employee Identification Number:
52-08393

JUL 30 2010

In re: Application for Change of Accounting Method
Form 3115 - See Appendix A

Dear Mr. Chesla:

This letter refers to a Form 3115, Application for Change in Accounting Method, filed by American Water Works Company, Inc. & Subs., EIN:51-0063696, on behalf of thirty applicants (see Appendix A) (collectively "the taxpayer"), requesting permission to change the taxpayer's method of accounting for: (1) costs to repair and maintain tangible property, and (2) dispositions of certain tangible depreciable property. The change is requested for the taxable period beginning January 1, 2008 and ending December 31, 2008 ("year of change").

The Department of the Treasury has published proposed regulations that clarify the application of §§ 162 and 263 of the Internal Revenue Code to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. See Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 FR 12838-01 (March 10, 2008), 2008-1 C.B. 871. A threshold issue in applying the rules under §§ 162 and 263 is determining the appropriate unit of property to which the rules should be applied. The proposed regulations reserve the rules for determining the appropriate unit of property for network assets, which are defined as railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines. See § 1.263(a)-3(d)(2)(iii)(C)(2) of the proposed regulations, 73 FR 12857. The preamble to the proposed regulations states that the unit of property for network assets should be addressed on an industry-by-industry basis in future Internal Revenue Bulletin guidance. See preamble discussion at 73 FR 12843.

Section 6.09 of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 16, provides that the Internal Revenue Service generally will not issue a letter ruling if the request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued. A letter ruling includes an Associate Office's response granting or denying a

request for a change in a taxpayer's accounting method. Section 2.01 of Rev. Proc. 2010-1. The unit of property determination for network assets is an issue that cannot be readily resolved before a regulation or other published guidance is issued. Further, because the taxpayer's proposed method of accounting is based on the unit of property determination, the propriety of the taxpayer's proposed method of accounting is also an issue that cannot be readily resolved. Thus, the Service declines to rule on whether the taxpayer's unit of property determination for its network asset is correct, and accordingly, whether its proposed method of accounting is a proper method of accounting.

Further, pursuant to section 4.02(1) of Rev. Proc. 2010-3, 2010-1 I.R.B. 110, 118, the Service will not ordinarily issue a letter ruling or determination letter on any matter in which the determination requested is primarily one of fact. The determination of the unit of property for dispositions of tangible depreciable property is a factual one. Thus, the Service declines to rule on whether the taxpayer is using the appropriate unit of property for determining dispositions of tangible depreciable property subject to its Form 3115 and, accordingly, whether its proposed method of accounting for determining dispositions of such property is a proper method of accounting.

FACTS

The taxpayer is a corporation that is in the business of operating as public water and wastewater utility company that pumps, treats, and distributes water to and from residential, commercial, and industrial customers in the United States. The taxpayer uses an overall accrual method of accounting. Its principal business activity code is 221300. The taxpayer is requesting permission to: (1) change its method of accounting for costs associated with the routine repair and maintenance of all of the taxpayer's network assets; and (2) change its units of property for determining dispositions of certain tangible depreciable property.

Routine repair and maintenance costs

The costs included in this request consist of costs associated with the routine repair and maintenance of taxpayer's tangible property. The taxpayer represents that these costs are incurred to keep the taxpayer's property in ordinarily efficient operating condition, and that they do not materially increase the value or substantially prolong the useful life of any unit of property compared to the value or useful life of the property before the general decline or event that led to the repairs or maintenance. The taxpayer represents that the repair and maintenance costs do not adapt any unit of property to a new or different use. The taxpayer represents that the repair and maintenance costs do not include costs to replace any unit of property or any major components or substantial

structural parts of any unit of property. The taxpayer represents that the repair and maintenance costs are not incurred as part of a plan of rehabilitation, modernization, or improvement to any unit of property. The taxpayer represents that the repair and maintenance costs do not result from any prior owner's use of any unit of property.

Section 162 allows a deduction for all the ordinary and necessary expenses paid during the taxable year in carrying on any trade or business.

Section 1.162-4 of the Income Tax Regulations allows a deduction for the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition.

Under the taxpayer's present method of accounting for repair and maintenance costs, the taxpayer capitalizes the repair and maintenance costs described above and recovers these costs using the appropriate method over the applicable recovery period and the applicable convention as prescribed by §168(a).

Under the taxpayer's proposed method of accounting for repair and maintenance costs, the taxpayer will treat the repair and maintenance costs as ordinary and necessary business expenses pursuant to §§ 162 and 1.162-4.

Disposition of certain tangible depreciable property

The items of tangible depreciable property subject to the taxpayer's request to change its units of property for determining dispositions are described as network assets. Such property is depreciated by the taxpayer under § 168.

The taxpayer represents that:

1. None of the assets that are the subject of the taxpayer's Form 3115 are leasehold improvements.

2. None of the assets subject to the taxpayer's Form 3115 is subject to a general asset account election under § 168(i)(4) and the regulations thereunder.

3. None of the assets subject to the taxpayer's Form 3115 is subject to a mass asset account election under former § 168(d)(2)(A).

4. Depreciation for all of the assets subject to the taxpayer's Form 3115 is not determined in accordance with § 1.167(a)-11 (regarding the Class Life Asset Depreciation Range System (ADR)).

5. None of the assets subject to the taxpayer's Form 3115 is subject to the repair allowance under § 1.167(a)-11(d)(2) (including expenditures incurred after December 31, 1980, that were for the repair, maintenance, rehabilitation, or improvement of property placed in service by the taxpayer before January 1, 1981).

6. None of the assets subject to the taxpayer's Form 3115 were disposed of in a transaction to which a nonrecognition section of the Code applies (for example, § 1031, transactions subject to § 168(i)(7)).

7. There is no building (and its structural components) that is the subject of the taxpayer's Form 3115.

Under the taxpayer's present method of accounting, the taxpayer uses a method other than the functional interdependence test to identify the unit of property for purposes of determining when a depreciable network asset is disposed of.

Under the taxpayer's proposed method of accounting, the taxpayer will use the functional interdependence test to identify the unit of property for purposes of determining when a depreciable network asset is disposed of. The taxpayer will use the same unit of property for purposes of determining when a depreciable network asset is placed in service (and when depreciation begins) and when the depreciable network asset is disposed of (and when depreciation ends).

The taxpayer has represented that, on the date the Form 3115 was filed, it was not under examination and it was not before an appeals office or a federal court with respect to any income tax issue. See sections 3.07, 3.08(2) and 3.08(3) of Rev. Proc. 97-27, 1997-1 C.B. 680, as modified by Rev. Proc. 2002-19, 2002-1 C.B. 696.

SECTION 481(a) ADJUSTMENT

The information provided indicates that, as of the beginning of the year of change, the required aggregate adjustment under § 481(a) (the § 481(a) adjustment) for the year of change is ($461,238,422). 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 netting represents a one-time exception allowed the taxpayer for the year of change based on its particular situation. As a rule, the netting of the § 481(a) adjustment for maintenance and repairs with the § 481(a) adjustment for dispositions is not allowed under the provisions of Rev. Proc. 97-27. The § 481(a) adjustment for each applicant is shown in Appendix A. The net amount represents a decrease in computing taxable income.

American Water Works Company, Inc. & Subsidiaries
CAM-108421-09

CONSENT/TERMS AND CONDITIONS OF CONSENT

Based solely on the facts presented and representations made, permission is hereby granted the taxpayer to change its method of accounting from the present method to the proposed method, beginning with the year of change, provided that:

(1) The taxpayer takes the entire net § 481(a) adjustment into account in computing taxable income in the year of change. See section 2.02(1) of Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432.

(2) The taxpayer keeps its books and records for the year of change and for subsequent taxable years (provided they are not closed on the date it receives this letter) on the method of accounting granted in this letter. This condition is considered satisfied if the taxpayer reconciles the results obtained under the method used in keeping its books and records and the method used for federal income tax purposes and maintains sufficient records to support such reconciliation; and

(3) No portion of any net operating loss that is attributable to a negative § 481(a) adjustment may be carried back to a taxable year prior to the year of change that is the subject of any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's federal tax liability, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability. See section 5.02(4) of Rev. Proc. 97-27.

(4) None of the items of property subject to the taxpayer's Form 3115 is subject to a general asset account election under § 168(i)(4) and the regulations thereunder;

(5) None of the items of property subject to the taxpayer's Form 3115 is subject to a mass asset account election under former § 168(d)(2)(A);

(6) The taxpayer does not determine depreciation for any of the items of property subject to the taxpayer's Form 3115 in accordance with § 1.167(a)-11 (regarding the Class Life Asset Depreciation Range System (ADR));

(7) None of the items of property subject to the taxpayer's Form 3115 is subject to the repair allowance under § 1.167(a)-11(d)(2) (including expenditures incurred after December 31, 1980, for the repair, maintenance, rehabilitation, or improvement of property placed in service before January 1, 1981);

8) None of the cost (or a portion thereof) of the assets subject to the taxpayer's Form 3115 is expensed or amortized under any provision of the Code, regulations, or other published guidance in the Internal Revenue Bulletin (for example, § 179D, § 1400I); and,

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.

EFFECT OF THIS ACCOUNTING METHOD CHANGE

The accounting method change granted in this letter is a letter ruling pursuant to § 601.204(c) of the Statement of Procedural Rules. See also section 2.01 of Rev. Proc. 2010-1, 2010-1 I.R.B. at 6 (or any successor). The taxpayer ordinarily may rely on this letter ruling subject to the conditions and limitations described in Rev. Proc. 97-27.

However, the consent granted under this letter ruling for the taxpayer's requested change is not a determination by the Commissioner that the taxpayer is using the appropriate unit of property for determining dispositions of tangible depreciable property and does not create any presumption that the proposed unit of property is permissible

for such purposes. The director will ascertain whether the taxpayer's determination of its unit of property for dispositions of tangible depreciable property is correct.

Further, the taxpayer should not infer approval of any tax treatment not specifically stated in this letter ruling. For example, this letter does not address the application of § 263A, which generally requires taxpayers to capitalize certain direct and indirect costs of property produced or acquired for resale, or the propriety of the taxpayer's classification of property under § 168(e) or Rev. Proc. 87-56, 1987-2 C.B. 678. Further, this letter ruling does not imply approval of any tax treatment (including amounts that are part of the § 481(a) adjustment) when the Code, the regulations, or other published guidance provides specific limitations and/or prohibitions. The Service expresses no opinion on the propriety of the unit(s) of property the taxpayer proposes to use in determining the deductibility of repair and maintenance costs. The unit of property determination is a factual one within the jurisdiction of the director.

The director must apply the ruling in determining the taxpayer's liability unless the director recommends that the ruling should be modified or revoked. The director will ascertain whether (1) the representations upon which this ruling was based reflect an accurate statement of the material facts, (2) the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the Consent Agreement and Rev. Proc. 97-27, (3) there has been any change in the material facts upon which the ruling was based during the period the method of accounting was used, (4) there has been any change in the applicable law during the period the method of accounting was used, (5) the amount of the § 481(a) adjustment was properly determined, and (6) the taxpayer's determination of its unit of property is correct. In the case of (1), (2), (3), or (4) above, if the director recommends that the ruling should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2010-2, 2010-1 I.R.B. 90 (or any successor) will be followed. See section 11.01 of Rev. Proc. 97-27.

As noted above, the Department of the Treasury has published proposed regulations that clarify the application of §§ 162 and 263 to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. See Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 FR 12838-01 (March 10, 2008), 2008-1 C.B. 871. If final or temporary regulations are adopted with positions that are inconsistent with the method of accounting that the taxpayer implements in accordance with this letter ruling, the taxpayer will be required to follow any instructions in those final or temporary regulations concerning methods of accounting for the repair, improvement, or rehabilitation of tangible property for future taxable years.

AUDIT PROTECTION

An examining agent may not propose that the taxpayer change the same method of accounting as the method changed by the taxpayer under this ruling for a year prior to the year of change provided the taxpayer implements the change as proposed, in accordance with the terms and conditions of this ruling and Rev. Proc. 97-27, and the ruling is not modified or revoked retroactively because there has been a misstatement or an omission of material facts. See sections 9.01 and 9.02(1) of Rev. Proc. 97-27.

However, the Service may change the taxpayer's method of accounting for the same item for taxable years prior to the requested year of change if there is any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change. See section 9.02(4) of Rev. Proc. 97-27.

CONSENT AGREEMENT

If the taxpayer agrees to the terms and conditions set forth above, an individual with the authority to bind the taxpayer in such matters must sign and date the attached copy and return it within 45 days from the date of this letter to:

Internal Revenue Service
Attention: Innessa Glazman, CC:ITA:B01
P.O. Box 14095
Benjamin Franklin Station
Washington, D.C. 20044

The signed copy constitutes an agreement regarding the terms and conditions under which the change is to be effected ("Consent Agreement") within the meaning of § 481(c) and as required by § 1.481-4(b). The Consent Agreement shall be binding on both parties except that it will not be binding upon a showing of fraud, malfeasance, or misrepresentation of a material fact. In addition, a copy of the executed Consent Agreement must be attached to the taxpayer's federal income tax return for the year of change. For further instructions, see section 8.11 of Rev. Proc. 97-27. Alternatively, a taxpayer that files its returns electronically may satisfy this requirement by attaching a statement to its return that provides the date and control number of this letter ruling.

American Water Works Company, Inc. & Subsidiaries
CAM-108421-09

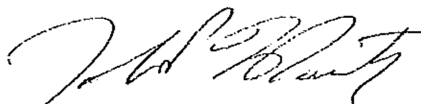
The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

The accounting method change granted in this letter is directed only to the taxpayer and may not be used or cited as precedent. See section 11.02 of Rev. Proc. 2010-1, 2010-1 I.R.B. at 49. Final or temporary regulations under § 167 or § 168 pertaining to one or more of the issues addressed in this letter ruling have not yet been adopted. Therefore, if final or temporary regulations under § 167 or § 168 should be adopted with positions that are inconsistent with the conclusions reached in this letter ruling, the method of accounting utilized as a result of the letter ruling will no longer be regarded as a proper method of accounting and would be subject to change within the framework of §§ 446 and 481.

American Water Works Company, Inc. & Subsidiaries
CAM-108421-09

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of the ruling letter to your authorized representatives.

Sincerely yours,



JOHN P. MORIARTY
Chief, Branch 1
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Philadelphia, PA 19103

Signed this 10th day

of September, 2010

American Water Works Inc & Subs,
(taxpayer)

By [signature], Vice President and Controller
(Name and corporate title of parent officer)