

# BUTLER | SNOW

September 19, 2018

**VIA ELECTRONIC FILING**

Hon. David Jones, Chairman  
c/o Sharla Dillon  
Tennessee Public Utilities Commission  
502 Deaderick Street, 4<sup>th</sup> Floor  
Nashville, TN 37243

**RECEIVED**

**SEP 19 2018**

**TN PUBLIC UTILITY COMMISSION  
DOCKET OFFICE**

**RE: *Petition of Tennessee-American Water Company in Support of the Calculation of the 2018 Capital Recovery Riders Reconciliation, Docket No. 18-00022***

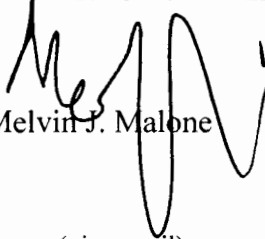
Dear Chairman Jones:

Attached for filing please find *Tennessee-American Water Company's Supplemental Response to the Consumer Protection and Advocate Division's First Set of Discovery Requests, Item 3 and Third Set of Discovery Requests, Item 10(c)* in the above-captioned matter.

As required, an original of this filing, along with four (4) hard copies, will follow. Should you have any questions concerning this filing, or require additional information, please do not hesitate to contact me.

Very truly yours,

BUTLER SNOW LLP



Melvin J. Malone

clw

**Attachments**

cc: Linda Bridwell, Tennessee-American Water Company (via e-mail)  
Daniel Whitaker, Assistant Attorney General, Consumer Protection and Advocate Division (via email)  
Karen H. Stachowski, Assistant Attorney General, Consumer Protection and Advocate Division (via email)

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**TENNESSEE AMERICAN WATER COMPANY  
DOCKET NO. 18-00022  
FIRST DISCOVERY REQUEST OF THE  
CONSUMER ADVOCATE AND PROTECTION DIVISION**

**Responsible Witness:**        **Linda C. Bridwell**

**Question:**

3.     Provide the underlying calculation of TAWC book and tax depreciation for each rider that reconcile to the amounts of book and tax depreciation contained within the composite tax filing that American Water Company (or any applicable affiliate) submitted, which contains TAWC data.

**Response:**

Similar to the response to question 1 of the CPAD's first discovery request in this docket, the data is pulled from the Rider and the tax calculations simulate the calculations in the tax returns since the tax return includes all TAWC property and not just the Rider property. See TAW\_R\_CPADDR1\_NUM003\_\_042718\_Attachment for a simulated calculation of our tax returns using the Rider assets. Note that the 2017 return is not filed yet, but the calculation is the same as what will be filed.

**Supplemental Response filed September 19, 2018:**

Per the response to Item 18 of the CPAD's Third Discovery Request, the 2017 calculation has been corrected. For each year, the Company took its repair deduction on the tax return and divided it by the total additions to come up with a percentage to use. For 2017, the percentage should be 30.19% instead of the 15.82% used in the original filing. This has been corrected in cell S13, T13, X13, and Y 13 in the updated attachment.

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

**CALCULATION OF TAX DEPR with Bonus & Repairs:**

	2014 5 Year	2014 25 Year	2014 39 Year	2014 Total	2015 5 Year	2015 25 Year	2015 39 Year	2015 Total
UPIS ADDITIONS	219,399	6,465,466	138,428		261,975	14,547,173	9,555,958	
CIAC BALANCE	-	-	-		-	-	-	
GRAND TOTAL BALANCE	219,399	6,465,466	138,428		261,975	14,547,173	9,555,958	
REPAIRS		1,482,531				2,576,304	1,692,360	
UPIS TAX BASIS BALANCE	219,399	4,982,935	138,428		261,975	11,970,869	7,863,598	
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	50%	109,699	2,491,467	138,428	130,988	5,985,434	7,863,598	
Tax Rate Year 1	20.00%	2.00%	1.28%		20.00%	2.00%	1.28%	
Tax Rate Year 2	32.00%	4.00%	2.56%		32.00%	4.00%	2.56%	
Tax Rate Year 3	19.20%	4.00%	2.56%		19.20%	4.00%	2.56%	
Tax Rate Year 4	11.52%	4.00%	2.56%		11.52%	4.00%	2.56%	

**Book/Tax Adjustment-Depr. Calculation**

Repairs	-	(1,482,531)	-		-	(2,576,304)	(1,692,360)	
Bonus Depreciation (rate x additions)	(109,700)	(2,491,468)	-		(130,987)	(5,985,435)	-	
Regular Yr 1 tax depreciation	(21,940)	(49,829)	(1,775)		(26,198)	(119,709)	(100,811)	
Regular Yr 2 tax depreciation					(35,104)	(99,659)	(3,549)	
Regular Yr 3 tax depreciation								
Regular Yr 4 tax depreciation								
Book Depreciation		39,779				294,063		
Net book/tax difference	(131,640)	(3,984,049)	(1,775)	(4,117,464)	(192,289)	(8,487,044)	(1,796,720)	(10,476,054)
Repairs related net b/t diff				(1,482,531)				(4,268,665)

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

**CALCULATION OF TAX DEPR with Bonus & Repairs:**

					Prior to October				After to October		
	2016 5 Year	2016 25 Year	2016 39 Year	2016 Total	2017 3 Year	2017 5 Year	2017 25 Year	2017 39 Year	2017 Total	2017 3 Year	2017 5 Year
UPIS ADDITIONS	180,161	5,603,587	8,289,269		100,405	372,571	11,743,085	(4,368,259)			294,535
CIAC BALANCE	-	(497,284)	-		-	-	(1,718,549)	-		-	-
GRAND TOTAL BALANCE	180,161	5,106,303	8,289,269		100,405	372,571	10,024,536	(4,368,259)		-	294,535
REPAIRS		1,835,205	2,979,163				3,026,407	(1,318,777)			
UPIS TAX BASIS BALANCE	180,161	3,271,097	5,310,105		100,405	372,571	6,998,128	(3,049,482)		-	294,535
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	50%	90,080	1,635,549	5,310,105	100,405	186,285	3,499,064	(3,049,482)		-	294,535
Tax Rate Year 1	20.00%	2.00%	1.28%		33.33%	20.00%	2.00%	1.28%		33.33%	20.00%
Tax Rate Year 2	32.00%	4.00%	2.56%		33.33%	32.00%	4.00%	2.56%		33.33%	32.00%
Tax Rate Year 3	19.20%	4.00%	2.56%		33.34%	19.20%	4.00%	2.56%		33.34%	19.20%
Tax Rate Year 4	11.52%	4.00%	2.56%			11.52%	4.00%	2.56%			11.52%

**Book/Tax Adjustment-Depr. Calculation**

Repairs	-	(1,835,205)	(2,979,163)			-	(3,026,407)	1,318,777			-
Bonus Depreciation (rate x additions)	(90,081)	(1,635,548)	-			(186,286)	(3,499,064)	-			-
Regular Yr 1 tax depreciation	(18,016)	(32,711)	(68,076)		(33,465)	(37,257)	(69,981)	39,094			(58,907)
Regular Yr 2 tax depreciation	(41,916)	(239,417)	(201,623)			(28,826)	(65,422)	(136,151)			
Regular Yr 3 tax depreciation	(21,062)	(99,659)	(3,549)			(25,150)	(239,417)	(201,623)			
Regular Yr 4 tax depreciation						(12,637)	(99,659)	(3,549)			
Book Depreciation		849,206					1,206,475				
Net book/tax difference	(171,075)	(2,993,335)	(3,252,411)	(6,416,820)	(33,465)	(290,156)	(5,793,476)	1,016,548	(5,100,548)	-	(58,907)
Repairs related net b/t diff				(4,814,368)					(1,707,630)		

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

**CALCULATION OF TAX DEPR with Bonus & Repairs:**

	2017 25 Year	2017 39 Year	2017 Total
UPIS ADDITIONS	5,534,138	1,127,247	
CIAC BALANCE	(90,857)	-	
GRAND TOTAL BALANCE	5,443,281	1,127,247	
REPAIRS	1,643,326	340,316	
UPIS TAX BASIS BALANCE	3,799,954	786,931	
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	50% 3,799,954	786,931	
Tax Rate Year 1	2.00%	1.28%	
Tax Rate Year 2	4.00%	2.56%	
Tax Rate Year 3	4.00%	2.56%	
Tax Rate Year 4	4.00%	2.56%	

**Book/Tax Adjustment-Depr. Calculation**

Repairs	(1,643,326)	(340,316)	
Bonus Depreciation (rate x additions)	-	-	
Regular Yr 1 tax depreciation	(75,999)	(10,088)	
Regular Yr 2 tax depreciation			
Regular Yr 3 tax depreciation			
Regular Yr 4 tax depreciation			
Book Depreciation			
Net book/tax difference	(1,719,325)	(350,404)	(2,128,636)
Repairs related net b/t diff			(1,983,642)

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

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CIAC BALANCE	-	-	-		-	-	-	
GRAND TOTAL BALANCE	219,399	6,465,466	138,428		261,975	14,547,173	9,555,958	
REPAIRS	-	1,482,531	-		-	2,576,304	1,692,360	
UPIS TAX BASIS BALANCE	219,399	4,982,935	138,428		261,975	11,970,869	7,863,598	
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	100% 219,399	4,982,935	138,428		261,975	11,970,869	7,863,598	
Tax Rate Year 1	20.00%	2.00%	1.28%		20.00%	2.00%	1.28%	
Tax Rate Year 2	32.00%	4.00%	2.56%		32.00%	4.00%	2.56%	
Tax Rate Year 3	19.20%	4.00%	2.56%		19.20%	4.00%	2.56%	
Tax Rate Year 4	11.52%	4.00%	2.56%		11.52%	4.00%	2.56%	

**Book/Tax Adjustment-Depr. Calculation**

Repairs	-	(1,482,531)	-		-	(2,576,304)	(1,692,360)	
Bonus Depreciation (rate x additions)	0	0	-		(0)	0	-	
Regular Yr 1 tax depreciation	(43,880)	(99,659)	(1,775)		(52,395)	(239,417)	(100,811)	
Regular Yr 2 tax depreciation					(70,208)	(199,317)	(3,549)	
Regular Yr 3 tax depreciation								
Regular Yr 4 tax depreciation								
Book Depreciation		39,779				294,063		
Net book/tax difference	(43,880)	(1,542,411)	(1,775)	(1,588,066)	(122,603)	(2,720,975)	(1,796,720)	(4,640,299)

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

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<u>CALCULATION OF TAX DEPR with Bonus:</u>				Prior to October					After to October		
	2016 5 Year	2016 25 Year	2016 39 Year	2016 Total	2017 3 Year	2017 5 Year	2017 25 Year	2017 39 Year	2017 Total	2017 3 Year	2017 5 Year
UPIS ADDITIONS	180,161	5,603,587	8,289,269		100,405	372,571	11,743,085	(4,368,259)			294,535
CIAC BALANCE	-	(497,284)	-		-	-	(1,718,549)	-		-	-
GRAND TOTAL BALANCE	180,161	5,106,303	8,289,269		100,405	372,571	10,024,536	(4,368,259)		-	294,535
REPAIRS	-	1,835,205	2,979,163		-	-	3,026,407	(1,318,777)		-	-
UPIS TAX BASIS BALANCE	180,161	3,271,097	5,310,105		100,405	372,571	6,998,128	(3,049,482)		-	294,535
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	100%	180,161	3,271,097	5,310,105	100,405	372,571	6,998,128	(3,049,482)		-	294,535
Tax Rate Year 1	20.00%	2.00%	1.28%		33.33%	20.00%	2.00%	1.28%		33.33%	20.00%
Tax Rate Year 2	32.00%	4.00%	2.56%		33.33%	32.00%	4.00%	2.56%		33.33%	32.00%
Tax Rate Year 3	19.20%	4.00%	2.56%		33.34%	19.20%	4.00%	2.56%		33.34%	19.20%
Tax Rate Year 4	11.52%	4.00%	2.56%			11.52%	4.00%	2.56%			11.52%

**Book/Tax Adjustment-Depr. Calculation**

Repairs	-	(1,835,205)	(2,979,163)			-	(3,026,407)	1,318,777			-
Bonus Depreciation (rate x additions)	0	(0)	-			0	(0)	-			-
Regular Yr 1 tax depreciation	(36,032)	(65,422)	(68,076)		(33,465)	(74,514)	(139,963)	39,094			(58,907)
Regular Yr 2 tax depreciation	(83,832)	(478,835)	(201,623)			(57,652)	(130,844)	(136,151)			
Regular Yr 3 tax depreciation	(42,125)	(199,317)	(3,549)			(50,299)	(478,835)	(201,623)			
Regular Yr 4 tax depreciation						(25,275)	(199,317)	(3,549)			
Book Depreciation		849,206					1,206,475				
Net book/tax difference	(161,989)	(1,729,574)	(3,252,411)	(5,143,973)	(33,465)	(207,740)	(2,768,892)	1,016,548	(1,993,548)	-	(58,907)

Tennessee American Water Company  
Capital Riders' Filing  
Calculation of Book/Tax Depreciation Differences  
For the Years Ended 2014-2017

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CIAC BALANCE	(90,857)	-	
GRAND TOTAL BALANCE	5,443,281	1,127,247	
REPAIRS	1,643,326	340,316	
UPIS TAX BASIS BALANCE	3,799,954	786,931	
UPIS TAX BASIS BALANCE AFTER BONUS DEPR	100% 3,799,954	786,931	
Tax Rate Year 1	2.00%	1.28%	
Tax Rate Year 2	4.00%	2.56%	
Tax Rate Year 3	4.00%	2.56%	
Tax Rate Year 4	4.00%	2.56%	

**Book/Tax Adjustment-Depr. Calculation**

Repairs	(1,643,326)	(340,316)	
Bonus Depreciation (rate x additions)	-	-	
Regular Yr 1 tax depreciation	(75,999)	(10,088)	
Regular Yr 2 tax depreciation			
Regular Yr 3 tax depreciation			
Regular Yr 4 tax depreciation			
Book Depreciation			
Net book/tax difference	(1,719,325)	(350,404)	(2,128,636)



**TENNESSEE AMERICAN WATER COMPANY  
DOCKET NO. 18-00022  
THIRD DISCOVERY REQUEST OF THE  
CONSUMER PROTECTION AND ADVOCATE DIVISION  
  
SUPPLEMENTAL RESPONSE TO ITEM 10(C)**

**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)**

[Click to open document in a browser](#)

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.

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.

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.

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.

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).

**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

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**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:

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



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

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: \*\*\*\*\*