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1992

PLR/TAM 9202035 - 9202001

[PLR 9202029 -- IRC Sec\(s\). 167, 10/15/1991](#)

Private Letter Rulings

Private Letter Ruling 9202029, 10/15/1991, IRC Sec(s). 167

UIL No. 0167.22-00; 0168.09-00

Headnote:

Reference(s): [Code Sec. 167;](#)

IRS FINDS CONSISTENCY PROBLEMS IN TREATMENT OF UTILITY'S ESTIMATED DEFERRED TAX RESERVE.

A regulated public utility is subject to the ratemaking jurisdiction of a commission. The utility has submitted to the commission a request for a rate increase. The request is based on a fiscal test year. In determining the maximum amount of the deferred tax reserve that may be excluded from the rate base, the utility applied the proration formula under regulation section 1.167(l)- 1(h)(6) to the estimated accruals to the reserve for certain fiscal years. The company then deducted from the test year average rate base the average of the estimated deferred tax reserves for certain fiscal years, as prorated.


The ratemaking commission objected to the utility's application of the proration formula, asserting that the formula should be applied only to the estimated accruals for the portion of the test year extending beyond the rate order's anticipated effective date. The commission would then deduct the estimated deferred tax reserve, as prorated, from the test year average rate base. Applying the proration formula to the deferred tax accruals, the commission said, is the functional equivalent of taking the weighted average of those accruals.


The company has challenged the commission's proposal, arguing that failure to apply the formula to all the estimated accruals to the deferred tax reserve would violate regulation section 1.167(l)- 1(h)(6). According to the utility, a test year based entirely on estimated financial data and extending beyond the effective date of the rate order is a purely future test period under the regulations. The company also argues that failure to apply the formula to all estimated tax accruals, or at least those for the test year,

would violate the  section 168(i)(9)(B) consistency requirement. The utility further argues that

deducting the estimated deferred tax reserve, as prorated by the commission, from the test year average rate base would violate the consistency requirement.

The Service has ruled against the company's position in two out of the three points of contention with the commission. The Service held that the failure to apply the proration formula to all estimated accruals to the deferred tax reserve for the test year, which is based entirely on estimated data and extends beyond the effective date of the rate order, will not violate regulation section 1.167(l)-1(h)(6). Second, the Service ruled that the failure to apply the proration formula to all the estimated deferred tax

accruals for the test year will not violate the consistency requirement of  section 168(i)(9)(B). And finally, the Service held that the failure to average the deferred tax reserve, as prorated, before

excluding the reserve from the average rate base will violate the consistency requirement of  section 168(i)(9)(B).

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Date: October 15, 1991

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In re: Normalization Ruling Request

Dear

This is in response to your request of June 11, 1991 for rulings under  section 1.167(l)-1(h)(6) of the

 section 168(i)(9)(B) of the Internal Revenue Code. A conference-of- right was held at the National Office on September 12, 1991. You represent the facts as follows.

The Company is a regulated public utility operating in northern State. It is a wholly owned subsidiary of the Parent. The Parent files a consolidated federal income tax return on a

fiscal yearend basis with the Internal Revenue Service Center in City 1. The Company and the Parent are subject to the examination jurisdiction of the District Director of Internal Revenue in City 2.

The Company is subject to the ratemaking jurisdiction of the Commission. The Company's request for a rate increase is pending before the Commission. This request is based on a fiscal

test year (ending

. The rate base for the test year is the average of the rate bases for

, and


These estimated rate bases were developed using actual financial data for the Company's

fiscal year and estimated data for its

and

fiscal years.

In determining the maximum amount of the deferred tax reserve that may be excluded from rate base,

the Company applied the proration formula under  section 1.167(l)-1(h)(6) of the regulations to the estimated accruals to the reserve for fiscal years

and

(in conference the Company proposed to prorate only the accruals for

). The Company then deducted from the test year average rate base the average of the estimated deferred tax reserves for


and

as prorated.


The Commission staff objects to the Company's application of the proration formula, arguing that the formula should be applied only to the estimated accruals for the portion of the test year extending beyond the rate order's anticipated effective date of

. The staff would then deduct the estimated deferred tax reserve, as prorated, from the test year average rate base. The staff maintains that applying the proration formula to the deferred tax accruals is the functional equivalent of taking the weighted average of these accruals.

The Company objects to the staff's proposal. First, the Company argues, failure to apply the formula to


all the estimated accruals to the deferred tax reserve would violate  section 1.167(l)-1(h)(6) of the regulations. According to the Company, a test year based entirely on estimated financial data and extending beyond the effective date of the rate order is a purely future test period under the regulations.


Second, the Company argues that failure to apply the formula to all estimated deferred tax accruals, at


least those for the test year, would violate the consistency requirement of  section 168(i)(9)(B) of the Code. According to the Company, where cost of service is computed on a month basis, then rate base adjustments, including application of the proration formula, must be computed on the same basis.


Third, the Company argues that deducting the estimated deferred tax reserve, as prorated by the Commission staff, from the test year average rate base also would violate the consistency requirement. according to the Company, if an average rate base is used in determining rates, then the maximum


amount of deferred taxes that may be deducted from rate base also must be averaged.


According to  section 168(f)(2) of the Code, an allowance for depreciation shall not be available for


any public utility property (within the meaning of ) 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 provides that the taxpayer must, in computing its tax expense for ratemaking purposes and for reflecting operating results in its regulated books of account, use a method of depreciation with respect to the public utility property that is the same as, and a depreciation period for such property that is no shorter


than, the method and period used to compute its depreciation expense for such purposes. Under 


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, one way the requirements of  section 168(i)(9)(A) will not be met is if, for ratemaking purposes, the taxpayer uses a procedure or adjustment that is inconsistent with

these 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.

In general, according to  section 167(l)-1(h)(1)(iii) of the regulations, the amount of federal income tax liability deferred as a result of the use of a different method of depreciation is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability.


Under  section 1.167(l)-1(h)(6)(i) of the regulations, a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in


determining the taxpayer's ratemaking tax expense.  Section 1.167(l)-1(h)(6)(ii) goes on to provide the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no- cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, than the amount of the reserve

account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.


Any public utility taking advantage of accelerated depreciation in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. The purpose of the normalization requirement is to preserve for public utilities the benefit of accelerated depreciation (the measure of this benefit is the difference between a company's federal income tax liability calculated using accelerated depreciation and the tax liability it would have were it to use straightline or a similarly nonaccelerated method of depreciation). This benefit is preserved by proscribing its "flow through" to current utility ratepayers (in its most common form, flow through is the process by which a reduction in current tax liability resulting from accelerated depreciation is reflected in utility rates as a current reduction in regulatory tax expense).

Although the normalization rules prohibit flowthrough, ratepayers are permitted to benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not limit whatever authority a regulatory agency might have to pass through to ratepayers the benefit of accelerated depreciation, but only require that any such passthrough take place over the period for which the taxes are deferred (any acceleration of this process is a form of flowthrough). S. Rep. No. 552, 91st Cong., 1st Sess. 173 (1969). A utility commission may establish rates to be charged a utility's customers that reflect the capital cost savings represented by accelerated depreciation, either by excluding the reserve for deferred taxes from the base upon which a utility's rate-of-return is calculated or by treating the deferred taxes as cost-free capital in determining a fair rate-of-return.


 Section 1.167(l)-1(h)(6) was added to the regulations in response to certain ratemaking practices

that resulted in flowthrough. Under  section 1.167(l)-1(h)(6)(i), the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in section 1.167(l)- 1(a)(1) of the regulations, "the rules provided in [section 1.167(l)- 1(h)(6)(i)] are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that any be excluded from the rate base or included in no-cost capital in determining such cost of services."


If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using

projected data, in whole or in part, then it must use the formula provided in  section

1.167(l)-1(h)(6)(ii) of the regulations to calculate the amount of deferred taxes excludable from rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time


these amounts are expected to be in the reserve. As explained in  section 1.167(l)-1(h)(1), "the formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer."

The purpose of the proration formula is the same as that of the requirement for consistent periods: to prevent the immediate flowthrough of the benefit of accelerated depreciation to ratepayers. The proration formula stops flowthrough by limiting the deferred tax reserve accruals that may be excluded from rate base according to the length of time these accruals are actually in the reserve account. Thus, the earnings on rate base that may be disallowed are limited so as to prevent flowthrough.

Critical to the interpretation of  section 1.167(l)-1(h)(6)(ii) of the regulations is the meaning of the terms "historical" and "future" in relation to the period for determining depreciation for ratemaking tax expense (this test period might not be coextensive with the taxpayer's test year; see, e.g., section 1.157(l)-1(h)(6)(iv) Example (2)). The meaning of these terms does not depend on the type or quality of the data used in the ratemaking process -- whether the data used is actual or estimated -- but on when the utility's rates become effective. The historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.


These date-based definitions of the terms "historical" and "future" are consistent with the purpose of normalization, which is to preserve for regulated utilities the benefit of accelerated depreciation as a source of cost-free capital. This cost-free capital is made available by prohibiting flowthrough. But whether or not flowthrough can be accomplished by means of a rate base exclusion depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.


If rates go into effect before the end of the test period, and none of the rate base reduction is prorated, then in regard to the portion of the period after the effective date, the utility is denied a current return for an accelerated depreciation benefit it is only projected to have. This procedure is a form of flowthrough, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the estimated accruals to the deferred tax reserve attributable to the


future portion of the test period are prorated according to the formula in  section 1.167(l)-1(h)(6)(ii), this reserve may be deducted from rate base in determining a utility's allowable return on capital. In other words, if estimated data is used in computing ratemaking tax expense and rate base exclusion, then the passage of time must be accounted for if flowthrough is to be avoided.

In regard to the portion of the test period prior to the effective date, however (where rates go into effect during this period), the opportunity to flow through the benefit of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve for this period, whether actual or estimated. Once a portion of a future period, a period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued over this period is no longer relevant (at the time the new rate order takes effect, at least some of the projected increases have accrued, and so some of the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Beyond the question of accounting for the passage of time is the question of whether the application of


the proration formula to less than the entire test period violates the consistency requirement of  section 168(i)(9)(B) of the Code (the Company does not argue that the proration formula itself violates


the consistency requirement).  Section 168(i)(9)(B)(i) provides that ratemaking procedures and adjustments must be consistent with the requirements of normalization accounting. This section was enacted to strengthen the prohibition against flowthrough accounting for accelerated depreciation. H.R. Rep. No. S27, 97th Cong., 2d Sess. 3 (1982). Since the opportunity to flowthrough the benefit of future accelerated depreciation to current ratepayers does not exist for the portion of the test period that is prior to a rate order's effective date, then the failure to apply the proration formula to the estimated deferred tax accruals for this period can not violate the consistency requirement.

More specifically, for purposes of properly accounting for any deferred taxes,  section 168(i)(9)(B)(ii) of the Code provides that ratemaking estimates or projections of tax expense, depreciation expense, and the reserve for deferred taxes must be consistent with each other and with the estimate or projection of rate base. The Company argues under this provision that all adjustments to rate base, including proration, must be computed over the same period as is cost of service. Yet consistent periods clearly are maintained in the current situation; tax expense, depreciation expense, deferred tax reserve, and rate base are all estimated or projected for the Company's test year (fiscal


Proration is an adjustment affecting rate base, but it does not change the fact that the rate base is estimated or projected for the Company's test year.

Proration of the projected accruals to the deferred tax reserve is a discreet adjustment; its purpose is not to properly account for deferred taxes but to account for the passage of time in determining the amount of the reserve that may be excluded from rate base. Though the proration formula is applied to reserve accruals, this proration is not an adjustment to the reserve. Application of the proration formula does not affect the actual amount of accumulated deferred taxes. The amount of deferred taxes to be amortized when book/tax depreciation differences turn around does not change.

Though the regulations under  section 167 of the Code were promulgated before the enactment of


the consistency provisions of  section 168(i)(9)(B), they give a good indication that the proration formula does not run afoul of the consistency requirement, or more accurately in this situation, the

requirement of consistent periods.  Section 1.167(l)-1(h)(6)(i) of the regulations provides for

consistent periods in determining the amount of the rate base exclusion, followed by  section 1.167(l)-1(h)(6)(ii), which provides for the proration of deferred tax accruals attributable to any future portion of the test period. Clearly, in regards to determining the maximum amount of deferred taxes


excludable from rate base, consistency and timing are two separate, though related, issues.


The final question raised by the Company concerns the deduction of the estimated deferred tax reserve, as prorated under this ruling, from the estimated average rate base. The Company argues that the failure to average the entire prorated reserve in this situation would violate the consistency

requirement of  section 168(i)(9)(B) of the Code. The Commission staff responds that proration is the functional equivalent of averaging; if accruals to the deferred tax reserve are properly prorated, then averaging the prorated reserve would result in an average of an average.

The staff's position confuses function with purpose. Proration is mathematically similar to averaging, but the two techniques serve different purposes. Proration is a crude way of discounting the amount of deferred taxes (cost-free capital) the utility expects to recognize sometime in the future. Averaging, on the other hand, is simply the Commission's chosen method of estimating the test year rate base (it very well could have projected an end-of-period rate base, for example). Both ends are legitimate, but they can not be served by one means.


If an average test year rate base is used in developing rates, all rate base components, including the deferred tax reserve, must be averaged. If the proration of deferred tax accruals substitutes for taking

the average of the entire reserve, then the consistency requirement of  section 168(i)(9)(B) will be violated (the projected deferred tax reserve will not be consistent with the projected rate base). Likewise, if a portion of the test year is a future period, projected accruals to the deferred tax reserve must be prorated. If averaging of the entire reserve substitutes for this proration, then the timing


requirement of  section 1.167(l)-1(h)(6) will be violated (too much will be excluded from rate base, thus denying the utility a return on "capital" it is only projected to have).

Accordingly, based solely on the information provided by the Company above, and viewed in light of the applicable law and regulations, we rule as follows.

1) Failure to apply the proration formula to all estimated accruals to the deferred tax reserve for the test year, which is based entirely on estimated data and extends beyond the effective date of the rate order,

 section 1.167(l)-1(h)(6) of the regulations. The estimated deferred tax accruals for the portion of the test year prior to the rate order's effective date need not be prorated.


2) Failure to apply the proration formula to all the estimated deferred tax accruals for the test year WILL

NOT violate the consistency requirement of  section 168(i)(9)(B) of the Code.

3) Failure to average the deferred tax reserve, as prorated, before excluding the reserve from the

average rate base WILL violate the consistency requirement of  section 168(i)(9)(B).

In accordance with the power of attorney on file at this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it.  Section 6110(j)(3) of the Code provides that a private letter ruling may not be used or cited as precedent.

Sincerely,

Charles B. Ramsey

Chief, Branch 6

Office of Assistant Chief Counsel

(Passthroughs & Special

Industries)

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