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Date:
March 24, 2022

In Re:

LEGEND:

Taxpayer =

Parent =

State =

Commission =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

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Date 7 =

Date 8 =

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Month 1 =
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a =
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Dear :

This letter responds to a request for a private letter ruling dated September 22, 2021, and additional submission dated November 19, 2021, submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations regarding the application of the deferred tax normalization requirements and the appropriate methodology for the reduction of the accumulated deferred income tax ("ADIT") balance that decreases rate base computation when a net operating loss carryforward ("NOLC") exists. An earlier letter ruling (PLR 202010002, dated December 3, 2019, "2020 Ruling") to Taxpayer addressed this issue, but judicial and regulatory developments since the issuance of the 2020 Ruling have clarified pertinent regulatory matters and must be taken into account to apply the normalization rules.

Taxpayer's representations in the earlier letter ruling and those in the current request are as follows:

Taxpayer is a water and wastewater utility company that operates in State with rates set by Commission for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings (resulting in what are commonly referred to as "base rates") and infrastructure surcharge proceedings (resulting in surcharges that are added to base rates).

Under State statute and Commission rulemaking, eligible water corporations may petition Commission and utilize an Infrastructure System Replacement Surcharge ("Surcharge") to recover the costs of eligible water utility main replacements and relocations.

For both general rate case proceedings and Surcharge proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation and ADIT, and a recovery of operating

expenses, including depreciation expense, property tax expense, and income tax expense.

A State statute authorizes Commission to enter an order authorizing the water corporation to impose a Surcharge that is sufficient to recover "appropriate pretax revenues." The State statute defines the revenue requirement set in a Surcharge proceeding and provides that "appropriate pretax revenues" are "the revenues necessary to produce net operating income equal to . . . the water corporation's 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 . . ." among other items.

In the request resulting in the 2020 Ruling, Taxpayer represented that Commission and the State courts have interpreted this statute in a strict manner thereby limiting the costs eligible for recovery or to earn a return in a Surcharge proceeding and causing costs not eligible for ratemaking consideration in a Surcharge proceeding to only be eligible for recovery or return in the next base rate proceeding. As described below, a court decision after issuance of the 2020 Ruling has clarified the applicable interpretation of this statute.

The deferred tax normalization matters in the original request and in this request pertain to the Surcharge proceeding initiated by Taxpayer in Month 1 Year 1 (the "Surcharge Case") and resulting in a Commission order on Date 1 (the "Date 1 Order"). The Surcharge Case relates to additions of certain property placed in service from Date 2 through Date 3 and accumulated depreciation and estimated ADIT on such assets was through Date 4. The Surcharge resulting from the Surcharge Case became effective on Date 5.

On a consolidated basis, Parent incurred tax losses in various years from Year 2 to Year 3 and, as of Date 6, had an NOLC of approximately \$a. On a separate company basis, Taxpayer incurred tax losses in various tax years from Year 2 to Year 4 and, as of Date 6, had a separate company NOLC of approximately \$b (after tax-sharing payments). For Year 1, Parent (on a consolidated basis) and Taxpayer (on a separate company basis) estimated and then ultimately reported that taxable income was earned and, thus, NOLC was utilized.

As of the date of the rate base determination (Date 4), a taxable loss of approximately \$c had been incurred with respect to the plant-related expenditures with rates set by the Surcharge Case and associated Surcharge revenues as of such date. However, Taxpayer reported taxable income for the tax year that included the Surcharge Case test period on the basis of all of the gross income and deductions from Commission-regulated operations.

The NOLC reflected in ratemaking for the base rate case proceeding with rates effective in Month 2 Year 1 was based on the estimated NOLC as of the end of Year 4

of \$d, including an estimated Year 4 tax loss of \$e. The actual Year 4 tax loss reported on the Year 4 tax return was \$f. The excess of the actual Year 4 tax loss over the estimated Year 4 tax loss had yet to be reflected in ratemaking at the time of the Surcharge Case but was reflected in the subsequent base rate case.

Issues disputed by participants in the Surcharge Case included whether the tax effect of an NOLC must, pursuant to the normalization requirements, decrease the ADIT reduction to rate base related to the expenditures in the Surcharge Case and, if so, the methodology to determine the amount of the NOLC adjustment subject to the normalization requirements. The revenue requirement approved in Commission's Date 1 Order was lower than the revenue requirement sought by Taxpayer and is entirely attributable to differing ADIT calculations with respect to the NOLC and the resulting effects on rate base and allowed return. The approved revenue requirement in the Surcharge case was based on a rate base computation that reflects the gross ADIT liabilities associated with depreciation-related and repair-related book/tax differences, but did not reflect an ADIT asset for any portion of Taxpayer's NOLC as of the date that rate base was determined (Date 4), including the tax loss resulting from the infrastructure expenditures addressed in the Surcharge Case.

On Date 7, Taxpayer filed an Application for Rehearing and Motion to Defer Ruling, asking the Commission for the time to seek a private letter ruling form of guidance from the Service to address any uncertainties regarding the application of the deferred tax normalization requirements to the rate base treatment of the NOLC-related ADIT asset in computing the Surcharge case revenue requirement. On Date 8, the Commission denied Taxpayer's request for rehearing. Taxpayer filed a notice of appeal by Date 9, that initiated an appeal of the order in the Surcharge case to the State Court of Appeals. Taxpayer filed a private letter ruling request that resulted in the 2020 Ruling.

Taxpayer received the 2020 Ruling on Date 10 and notified the Commission that it had been received by way of correspondence dated Date 11.

On Date 12, Taxpayer filed a petition with Commission seeking to establish a Surcharge rate to provide for the recovery of costs for eligible infrastructure system replacements and relocations for a test period that included such date. In addition, Taxpayer sought to recover the incremental revenue requirement associated with the Surcharge Case attributable to the holdings of the 2020 Ruling.

As part of this Surcharge proceeding, Commission Staff filed its recommendation and memorandum agreeing with Taxpayer's calculations and recommending the Commission approve Taxpayer's requested rate changes including an adjustment related to the NOLC normalization matter in the Surcharge Case and subsequent Surcharge proceedings prior to the Surcharge proceeding initiated on Date 12. Another participant in the regulatory proceeding filed its objections and a request for an evidentiary hearing. The Commission conducted an evidentiary hearing and issued an

order on Date 13 with respect to this Surcharge proceeding ("Date 13 Order") that permitted the rate recovery sought by Taxpayer with respect to the NOLC-related normalization matter addressed in the 2020 Ruling for the periods covered by the Surcharge Case and subsequent Surcharge proceedings prior to the Surcharge proceeding initiated on Date 12.

The participant in the regulatory proceeding that had filed objections during this Surcharge proceeding subsequently filed a motion for rehearing related to the Date 13 Order. The Commission denied the application for rehearing. This participant then filed a Notice of Appeal with Commission and initiated litigation against the Commission and Taxpayer in the State Court of Appeals with respect to the Date 13 Order.

On Date 14, the State Court of Appeals rendered an opinion requiring the Commission to reduce its revenue requirement calculation for the Surcharge Case to eliminate the component attributable to the NOLC-related normalization matter ("Date 14 Decision"). The State Court of Appeals held that the Commission misinterpreted holding 9 of the 2020 Ruling and further held that whether an NOL exists for a test period is based on the entirety of the taxpayer's Commission-regulated operations, not simply the gross income and deductions for a particular Surcharge proceeding. The Date 14 Decision remands the Date 13 Order to the Commission and orders reduction of Taxpayer's computation of rate base for the Surcharge Case by reflecting depreciation-related ADIT subject to the deferred tax normalization requirements without reduction for Taxpayer's NOLC.

On Date 15, Taxpayer filed an Application for Rehearing or Motion to Transfer with State Court of Appeals, asking that the Court rehear the matter or, in the alternative, transfer the case to the State Supreme Court. On Date 16, the State Court of Appeals denied the motion for rehearing and denied transfer of the case to the State Supreme Court.

On Date 17, Taxpayer filed an Application for Transfer to the State Supreme Court and on Date 18, the State Supreme Court denied the application. Taxpayer has no further avenues to appeal the Date 14 Decision.

In accordance with the Date 14 Decision, the Date 13 Order was remanded back to Commission, and Commission had 60 days (subject to extension) to issue a revised order. At the time this ruling request was submitted to this office, Taxpayer expected Commission to comply with the Date 14 Decision and revise the Surcharge Case revenue requirement computation in a manner contradictory to holding 9 of the 2020 Ruling. On Date 19, Commission issued an order on remand, effective Date 20, with respect to the rate refund resulting from the Date 14 Decision. As expected, the Commission ordered Taxpayer to refund amounts that were previously recovered from customers in accordance with the original interpretation by Taxpayer and the Commission of holding 9 of the 2020 Ruling. Taxpayer intends to set prices in accordance with this order.

Holding 9 of the 2020 Ruling was premised on Taxpayer's interpretation of the statute and applicable regulatory and judicial precedent that considered Taxpayer's NOLC to be increasing during the Surcharge Case test period for purposes of setting the Surcharge. Based on the clarification provided by the Date 14 Decision, Taxpayer submitted a revision to its facts represented in the earlier ruling request to reflect that Taxpayer is instead considered to have decreased its NOLC during the Surcharge Case test period for purposes of setting the Surcharge. Thus, the analysis resulting in holding 9 of the 2020 Ruling must be reconsidered.

RULINGS REQUESTED

Taxpayer requests that the Service rule:

Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is not required to be decreased to reflect any portion of Taxpayer's NOLC existing during the test period for the Surcharge Case because Taxpayer expected to decrease its NOLC during the Surcharge Case test period and the remaining depreciation-related NOLC was reflected in ADIT used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

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) 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 § 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.

Former § 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 § 167(l)(3)(G)

in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the 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 § 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 (l) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a NOL 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 (l) 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(l) 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)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of § 1.167(l)-(h), 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)-(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) of § 1.167(l)-(h)(6), 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.

Therefore, § 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.

The normalization requirements pertain only to deferred income taxes for public utility property resulting from the use of accelerated depreciation for tax purposes and the use of straight-line depreciation for establishing cost of service and reflecting the operating results in regulated books of account. Generally, amounts that do not actually defer tax because of the existence of an NOL need to be reflected as offsetting entries to the ADIT account to show the portion of tax losses which did not actually defer tax due to accelerated depreciation.

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. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the ADIT asset resulting from the NOLC should be included in rate base, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

Section 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.

At issue in the Surcharge Case is the computation of the amount by which Taxpayer's NOLC as of the rate base determination date for the Surcharge Case is attributable to depreciation-related book/tax differences pertaining to expenditures for public utility property which are reflected in the Surcharge Case and subject to § 1.167(l)-1(h)(1)(iii). Based on the State statute and judicial decisions, whether an NOL exists for a Surcharge proceeding test period and, thus, whether an overall NOLC existing prior to such test period is increasing or decreasing during a Surcharge proceeding test period are based on gross income and deductions related to all of Taxpayer's Commission-regulated operations during such test period and are not limited to the gross income and deductions pertaining to the Surcharge Case in isolation.

Taxpayer has indicated that all of the property placed in service in the test period for the Surcharge Case was placed in service in Year 1. During Year 1, gross income of Taxpayer exceeded deductions allowed of Taxpayer and, thus, an NOL as defined in § 172(c) of the Code did not occur. Similarly, gross income of the consolidated group exceeded deductions allowed of the consolidated group and, thus, an NOL as defined in § 172(c) of the Code did not occur on a consolidated basis either. Accordingly, during Year 1, both Taxpayer and its consolidated group utilized a portion of their NOLCs existing at the end of Year 4. No portion of the NOLC of Taxpayer at the beginning or end of the test period for the Surcharge Case is attributable to depreciation of public utility property with rates set in the Surcharge Case. Instead, depreciation of Surcharge Case public utility property reduced current-year (Year 1) taxable income.

On this basis, taxable income rather than an NOL resulted during the Surcharge Case test period and, thus, Taxpayer's NOLC decreased during the Surcharge Case test period. The NOLC normalization requirement of § 1.167(l)-1(h)(1)(iii) does not apply to depreciation-related book/tax differences pertaining to expenditures for public utility property reflected in the Surcharge Case because Taxpayer's NOLC did not arise or increase due to the Surcharge Case depreciation-related book/tax differences with respect to public utility property. Significantly, Taxpayer's depreciation-related NOLC is reflected in the ADIT amount used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

CONCLUSION

Based on the foregoing, we conclude as follows:

Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is not required to be decreased to reflect any portion of Taxpayer's NOLC existing during the test period for the Surcharge Case because Taxpayer expected to decrease its NOLC during the Surcharge Case test period and the remaining depreciation-related NOLC was reflected in ADIT used to compute rate base in the base rate proceedings immediately preceding and immediately subsequent to the Surcharge Case.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/s/

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

Enclosure:

Copy for § 6110 purposes

cc: