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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

An IRS Lifeline To Public Utilities On Normalization

By **Jeffrey Davis, David Burton and Isaac Maron**
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On Sept. 7, the Internal Revenue Service issued Revenue Procedure 2017-47 to provide a safe harbor for public utilities that inadvertently or unintentionally use a practice or procedure that is inconsistent with the so-called normalization rules. Before describing the revenue procedure, we first discuss the basics of normalization.

Jeffrey Davis

Normalization is an accounting system provided for by Treasury regulations that is used by regulated public utilities to reconcile the tax treatment of the investment tax credits (ITC) set forth in section 46 of the Internal Revenue Code of 1986 or accelerated depreciation of public utility assets under section 168 of the Code with their regulatory treatment.

David Burton

Although the ITC generally was repealed with respect to "public utility property" (i.e., property that earns a regulated return set by a public utility commission (PUC) (which has different names in different states)) that was placed in service after 1985, normalization remains relevant with respect to the ITC due to the long economic useful lives of much public utility property. Thus, Revenue Procedure 2017-47 addresses the ITC, not because solar projects (or other renewable projects) that earn a regulated return would currently qualify for the ITC, but because public utility property up until 1985 qualified for the ITC and some of that property is still being used and included in utility rate-making calculations as described below.

Isaac Maron

Understanding normalization requires an understanding of certain fundamentals of rate-making for regulated utilities. As a general matter, a regulated utility is entitled to earn an after-tax return on its investments in its utility system. The PUC that regulates the utility then sets the rates paid by customers for the utility service (e.g., electricity) to allow the utility to earn that after-tax return on its investments. In setting those rates, the PUC must determine economic depreciation for the utility's assets and "tax expense."

For rate-making purposes, the economic depreciation for the utility's assets is not based on tax depreciation, as that would result in unnecessarily high rates for

consumers due to the utility's assets being depreciated over a period shorter than the period they are expected to be used by the utility. Rather, assets are depreciated over their economic useful lives in a manner similar to financial accounting depreciation. This economic useful life is longer (sometimes significantly so) than the "recovery period" used for income tax depreciation purposes.

The "tax expense" PUCs allow in the rate-making calculation generally follows the income tax law. However, the normalization rules in the Code require the calculation of "tax expense" to vary from how utilities actually file their tax returns. Normalization requires for purposes of calculating tax expense for rate-making purposes that assets be assumed to be depreciated over their economic life used for rate-making purposes.

For instance, this may be 30 years for a solar project, rather than the five-year recovery period used in filing a tax return. Further, rather than the ITC being recognized in the year a renewable energy project is placed in service, the ITC benefit for rate-making purposes must be recognized over the economic useful life used for rate-making purposes (e.g., 30 years).

So long as the tax expense for rate-making purposes is properly calculated, the utility files its income tax returns just like any other C corporation, with MACRS depreciation and the ITC recognized in the year of placement in service. However, if the utility does not properly follow the normalization rules for any asset, then the asset in question is subject to depreciation straight-line over the class life (e.g., 12 years for solar) and is ineligible for the ITC.

As explained in the revenue procedure, the normalization rules are intended to discourage the flow through of tax benefits to customers in order to accomplish two primary goals.

First, the accelerated depreciation and the original ITC were enacted to stimulate investment, not to subsidize consumption of utility products or services. Because public utility rates are set based on the utility's costs incurred to provide service, including federal income tax expense, Congress was concerned that the value of accelerated depreciation and the ITC would effectively be offset by reduced utility prices, thereby thwarting the purpose of these tax benefits. Normalization alleviates this concern by allowing the utility to capture the full benefit of the tax incentives upfront, while passing on the benefit to customers over a longer period of time.

Second, Congress was concerned that the combination of accelerated depreciation and the resulting lower utility rates (and thus less taxable income to utilities) would result in a double reduction in tax revenue for the government. Normalization delays the impact of the tax benefits in determining tax expense for rate-making purposes, resulting in customers paying higher rates to the utility and thereby increasing the government's tax revenue.

Revenue Procedure 2017-47 does not change or modify the normalization rules in any manner. Rather, it provides a safe harbor, pursuant to which the IRS will not assert that a taxpayer's inadvertent or unintentional use a practice or procedure that is inconsistent with normalization constitutes a violation of the normalization rules (which otherwise would jeopardize the taxpayer's claim of the ITC or accelerated depreciation).

For these purposes, a taxpayer's inconsistent practice or procedure is not inadvertent or unintentional (and thus the safe harbor is inapplicable) if the taxpayer's PUC specifically considered and specially addressed the application of the normalization rules to such practice or procedure in establishing or approving the taxpayer's rates.

To be within the safe harbor, a taxpayer that owns public utility property and inadvertently or unintentionally uses a practice or procedure that is inconsistent with the normalization rules must satisfy the following requirements:

1. Upon recognizing its failure to comply with the normalization rules, the taxpayer must change its inconsistent practice or procedure to a consistent practice in the current or, if inapplicable, next available proceeding in which the taxpayer's PUC establishes or approves the taxpayer's rates in a manner that totally reverses the effect of the inconsistent practice or procedure, provided the taxpayer's PUC adopts or approves the change; and
2. The taxpayer must retain contemporaneous documentation that clearly demonstrates the effects of the inconsistent practice or procedure and the change to a consistent practice or procedure adopted or approved by the taxpayer's PUC.

Further, for any tax year ending after the taxpayer has identified an inconsistent practice or procedure but has not changed to a consistent practice or procedure because the taxpayer has not reached the year that presents the taxpayer with a proceeding with its PUC, the taxpayer must include in its return a statement that identifies the inconsistent practice or proceeding and includes a representation by the taxpayer of its intention to change to a consistent practice or procedure at the next available opportunity.

While Revenue Procedure 2017-47 is effective for years ending on or after Dec. 31, 2016, the revenue procedure notes that the IRS will not challenge any inconsistent practice or procedure in any earlier taxable year, provided that the taxpayer complies with the safe harbor and the reporting requirements.

This revenue procedure is good news for public utilities that claimed the ITC, or claimed or will claim accelerated depreciation, and in no way does it limit or change the process by which a taxpayer may request a letter ruling or a referral for a technical advice memorandum that the taxpayer's proposed practice or procedure is consistent or inconsistent with the normalization rules.

Jeffrey G. Davis and David K. Burton are partners and Isaac Maron is an associate at Mayer Brown LLP.

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