

Safe Harbor for Inadvertent Normalization Violations

Rev. Proc. 2017-47

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor concerning inadvertent or unintentional uses of a practice or procedure that is inconsistent with §§ 50(d)(2) and 168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), which require the use of the Normalization Rules (as defined in section 4.04 of this revenue procedure). If the safe harbor under section 5 of this revenue procedure applies, the Internal Revenue Service (Service) will not assert that a taxpayer's inadvertent or unintentional use of a practice or procedure that is inconsistent with §§ 50(d)(2) and 168(i)(9) of the Code constitutes a violation of the Normalization Rules. This revenue procedure does not 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.

SECTION 2. BACKGROUND

In general, normalization is a system of accounting used by regulated public utilities to reconcile the tax treatment of the Investment Tax Credit (ITC) or accelerated depreciation of public utility assets with their regulatory treatment. Under normalization, a utility receives the tax benefit of the ITC or accelerated depreciation in the early years

of an asset's regulatory useful life and passes that benefit on to ratepayers ratably over the regulatory useful life in the form of reduced rates. The remainder of this section 2 describes the intent of Congress in adopting the Normalization Rules and their operation under the Code and Income Tax Regulations.

.01 Congressional Intent. Congress had two principal objectives in adopting the Normalization Rules. The first objective was to preserve the utility's incentive to invest. Congress enacted the ITC and accelerated depreciation to stimulate investment. These incentives were not intended to subsidize the consumption of any products or services, including utility products or services. Recognizing that public utility rates are set based on the utility's costs incurred to provide the utility service, including federal income tax expense, Congress enacted a set of rules to assure that some or all of the value of the incentives it provided for utility capital investment would not be diverted from investment by utilities to lower prices for consumption by customers of utilities.

The second objective was to protect the government's tax revenue. Congress reasoned that when a utility elected accelerated depreciation and its regulator lowered rates to reflect the resulting tax benefit, the federal government would experience a reduction in tax revenue twice: once from the added accelerated depreciation deductions taken by the utility, and again from the decline in the revenue received by the utility as a result of its lower rates. See S. Rep. No. 91-552, at 17 (1969). The same impact results if a utility is permitted to flow through the benefit of its ITC to customers.

.02 Depreciation. Section 168 of the Code provides taxpayers generally with the

benefits of the accelerated cost recovery system in the computation of their depreciation deduction for federal income tax purposes. Section 168(f) provides the description of certain property for which the benefits of § 168 do not apply. Section 168(f)(2) provides that § 168 does not apply to any public utility property, as defined in § 168(i)(10), if the taxpayer does not use a normalization method of accounting. In general, § 168(i)(10) defines “public utility property” as property used predominantly in the trade or business of furnishing or selling (A) electrical energy, water, or sewage disposal services, (B) gas or steam through a local distribution system, (C) certain communications services, or (D) the transportation of gas or steam by pipeline, if rates for such furnishing or sale are established or approved by a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof.

Section 168(i)(9) describes what constitutes a “normalization method of accounting.” The rules provided in § 168(i)(9) recognize that the rates a regulated public utility is permitted to charge its customers are established or approved by regulators based on the utility’s cost of service taking into account the depreciation of assets and federal income tax expense. The Normalization Rules under § 168(i)(9)(A)(i) require the taxpayer to compute the federal income tax expense taken into account in setting its rates using a depreciation method that is the same as, and a depreciation period that is no shorter than, the method and period used to compute the depreciation expense for purposes of computing rates. Under § 168(i)(9)(A)(ii), a taxpayer must account for any

difference between its federal income tax expense taken into account in computing its rates and the actual federal income tax it pays as a reserve for deferred taxes. If the taxpayer uses estimates or projections in determining for rate-making purposes its tax expense, depreciation expense, or reserve for deferred taxes, the Normalization Rules under § 168(i)(9)(B) require the use of consistent estimates or projections with respect to the other two items and rate base.

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 § 167 of the Code 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.

.03 Investment Tax Credit. Section 46 of the Code sets forth certain investment credits against income tax. Section 50(d) provides special rules for certain taxpayers to qualify for those credits, including § 50(d)(2), which provides that rules similar to the limitations provided under former § 46(f) applicable to public utility property prior to the enactment of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Title XI, 104 Stat. 1388, shall apply to certain regulated companies. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, repealed the ITC generally with respect to public utility property placed in service after 1985; however, due to the long useful life of much public utility property, these provisions retain their vitality.

Under the general rule of former § 46(f), those regulated companies are not entitled to the ITC if either the taxpayer's cost of service or rate base for ratemaking purposes is reduced by any portion of the credit. However, the statute provides important exceptions. Former § 46(f)(1) provides that the ITC may not be used to reduce the taxpayer's cost of service, but may be used to reduce rate base, if such reduction is restored not less rapidly than ratably. Former § 46(f)(2) provides an election under which a taxpayer is permitted to take into account a ratable portion of the ITC for purposes of determining cost of service, but is not permitted to reduce the base to which the taxpayer's rate of return for ratemaking purposes is applied by any portion of the credit. A utility taxpayer elects either former § 46(f)(1) or former § 46(f)(2) and that choice applies to all public utility property of the taxpayer. A taxpayer that does not specifically elect former § 46(f)(2) is subject to the general rule of former § 46(f)(1).

Former § 46(f)(6) provides that for purposes of determining ratable portions, the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account is to be used. Under § 1.46-6(g)(2) of the Income Tax Regulations, "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. "Regulated depreciation expense" is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

.04 Application of Sanctions for Failure to Use a Normalization Method of Accounting. Former § 46(f)(4)(A) provides that there is no disallowance of a credit

before the first final inconsistent determination is put into effect for the taxpayer's former § 46(f) property. Section 1.46-6(f)(4) provides that the ITC is disallowed for any former § 46(f) property placed in service by a taxpayer (a) before the date a final inconsistent determination by a regulatory body is put into effect, and (b) on or after such date and before the date a subsequent consistent determination is put into effect.

Section 1.46-6(f)(7) provides that the term "determination" refers to a determination made with respect to former § 46(f) property (other than property to which an election under former § 46(f)(3) applies) by a regulatory body described in former § 46(c)(3)(B) that determines the effect of the credit (a) for purposes of former § 46(f)(1), on the taxpayer's cost of service or rate base for ratemaking purposes, or (b) for a taxpayer that made an election under former § 46(f)(2), on the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, or on the taxpayer's rate base for ratemaking purposes.

Section 1.46-6(f)(8)(i) provides that "inconsistent" refers to a determination that is inconsistent with former § 46(f)(1) or former § 46(f)(2). For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the ITC would be a determination that is inconsistent with former § 46(f)(2). Section 1.46-6(f)(8)(ii) provides that the term "consistent" refers to a determination that is consistent with former § 46(f)(1) or former § 46(f)(2). Section 1.46-6(f)(8)(iii) provides that the term "final determination" means a determination by a regulatory body with respect to which all rights of appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed.

The Senate Finance Committee Report to the Tax Reduction Act of 1975 addressed the importance of the final determination by stating that “if a regulatory agency requires the flowing through of a company’s additional investment credit at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, the additional investment credit is to be disallowed, but only after a final determination . . . is put into effect.” S. Rep. No. 94-36, at 44-45 (1975).

Unlike most tax provisions the sanctions imposed under the Normalization Rules were not intended to directly increase or decrease federal tax revenues. They were intended to discourage the flow through of tax benefits to customers in order to allow utilities to benefit from the underlying depreciation and ITC provisions and prevent the loss of revenue the federal government would suffer if the benefits were flowed through to customers.

In addition, in discussing the limitations on the ratemaking treatment of the ITC under § 46(e)(1) and (e)(2), the Senate Finance Committee Report concerning the Revenue Act of 1971, P.L. 92-178, 85 Stat. 497, indicates that the Committee hoped that the sanctions of disallowance of the ITC would not have to be imposed. S. Rep. No. 92-437, at 41 (1971).

SECTION 3. SCOPE

.01 This revenue procedure applies to a taxpayer that:

(1) owns Public Utility Property (as defined in section 4.03 of this revenue procedure);

(2) has inadvertently or unintentionally failed to follow a practice or procedure that

is consistent with the Normalization Rules (as defined in section 4.04 of this revenue procedure) in one or more years;

(3) upon recognizing its failure to comply with the Normalization Rules, the taxpayer changes its Inconsistent Practice or Procedure (as defined in section 4.06 of this revenue procedure) to a Consistent Practice or Procedure (as defined in section 4.05 of this revenue procedure) at the Next Available Opportunity (as defined in section 4.07 of this revenue procedure) in a manner that totally reverses the effect of the Inconsistent Practice or Procedure, provided the Taxpayer's Regulator (as defined in section 4.01 of this revenue procedure) adopts or approves the change; and

(4) retains 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 Regulator.

.02 For purposes of section 3.01(2) of this revenue procedure, a taxpayer's Inconsistent Practice or Procedure is neither inadvertent nor unintentional if the Taxpayer's Regulator specifically considered and specially addressed the application of the Normalization Rules to the Inconsistent Practice or Procedure in establishing or approving the taxpayer's rates even if at the time of such consideration the Taxpayer's Regulator did not believe the practice or procedure was inconsistent with the Normalization Rules.

SECTION 4. DEFINITIONS

.01 Taxpayer's Regulator

Taxpayer's Regulator means a State (including the District of Columbia) or political

subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof that establishes or approves the rates of the taxpayer.

.02 Rate Proceeding

Rate Proceeding means a proceeding in which the Taxpayer's Regulator establishes or approves the taxpayer's rates.

.03 Public Utility Property

Public Utility Property has the meaning provided in former § 46(f)(5) or in § 168(i)(10), and the applicable Income Tax Regulations.

.04 Normalization Rules

The Normalization Rules mean, in the case of the ITC, the rules provided by former § 46(f), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990, and the Income Tax Regulations thereunder, and, in the case of the accelerated cost recovery system for depreciation, the rules provided by § 168(i)(9), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990, and the Income Tax Regulations thereunder.

.05 Consistent Practice or Procedure

A Consistent Practice or Procedure means a practice or procedure followed by the taxpayer and the Taxpayer's Regulator that is consistent with the Normalization Rules.

.06 Inconsistent Practice or Procedure

An Inconsistent Practice or Procedure means a practice or procedure followed by the taxpayer and the Taxpayer's Regulator that is inconsistent with the Normalization Rules.

.07 Next Available Opportunity

(1) In the case of a taxpayer without a Rate Proceeding pending before the Taxpayer's Regulator, the Next Available Opportunity means the next Rate Proceeding.

(2) In the case of a taxpayer with a Rate Proceeding currently pending before the Taxpayer's Regulator, the Next Available Opportunity means the currently pending proceeding, unless the rules of the Taxpayer's Regulator or applicable state or federal law (at the time the Inconsistent Practice or Procedure is identified) preclude the taxpayer from initiating a change from an Inconsistent Practice or Procedure to a Consistent Practice or Procedure in the currently pending proceeding, in which case the currently pending proceeding shall not be the Next Available Opportunity, and the Next Available Opportunity means the next Rate Proceeding.

(3) If, at the conclusion of a Rate Proceeding, the taxpayer has a private letter ruling request pending before the Service to address whether or not a practice or procedure addressed in the Rate Proceeding is a Consistent Practice or Procedure, and the Taxpayer's Regulator later establishes or approves rates subject to adjustment from the effective date of the unadjusted rates in order to conform to the Service's ruling, the taxpayer shall have corrected its Inconsistent Practice or Procedure at the Next Available Opportunity.

SECTION 5. APPLICATION

.01 For any taxpayer described in section 3 of this revenue procedure, the Service will not assert that the Inconsistent Practice or Procedure constitutes a violation of the Normalization Rules and will not deny that taxpayer the benefits of the ITC and/or

accelerated depreciation. In any tax year ending after the taxpayer has identified an Inconsistent Practice or Procedure, but in which the taxpayer has not changed to a Consistent Practice or Procedure because the taxpayer has not reached the year that presents the taxpayer with its Next Available Opportunity, the taxpayer must include in its return a statement described in section 5.02 of this revenue procedure. If the taxpayer makes the representation described in section 5.02(3) of this revenue procedure, the Service will not assert that the Inconsistent Practice or Procedure is a violation of the Normalization Rules and will not challenge the taxpayer's use of the identified Inconsistent Practice or Procedure unless the taxpayer does not change to a Consistent Practice or Procedure at the Next Available Opportunity.

.02 A statement is described in this section 5.02 if:

- (1) The top of the statement is marked "FILED PURSUANT TO REV. PROC. 2017-47";
- (2) The statement identifies the taxpayer's Inconsistent Practice or Procedure; and
- (3) The statement includes a representation by the taxpayer of its intention to change to a Consistent Practice or Procedure at the Next Available Opportunity.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2016. However, the Service will not challenge any Inconsistent Practice or Procedure in any earlier taxable year provided that the requirements of sections 3 and 5 of this revenue procedure are satisfied by the taxpayer with respect to the

Inconsistent Practice or Procedure in such taxable year.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-2276.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information are in sections 3 and 5 of this revenue procedure and are required for a taxpayer to apply the safe harbor provided by this revenue procedure. This information is required to be collected and retained to clearly demonstrate the effects of a taxpayer's Inconsistent Practice or Procedure and the taxpayer's change to a Consistent Practice or Procedure adopted or approved by the Taxpayer's Regulator. The taxpayer must also include a statement in its federal income tax return identifying the Inconsistent Practice or Procedure and representing its intention to change to a Consistent Practice or Procedure at the Next Available Opportunity. The likely respondents are corporations or partnerships that are regulated public utilities.

The estimated total annual reporting burden is 1,800 hours.

The estimated annual burden per respondent varies from 10 hours to 14 hours, depending on individual circumstances, with an estimated average burden of 12 hours to collect and retain contemporaneous documentation and to complete the statement required under this revenue procedure. The estimated number of respondents is 150.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by § 6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jennifer C. Bernardini of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure contact Ms. Bernardini on (202) 317-6853 (not a toll free call).