

Determining whether a utility's ratemaking treatment of an NOL carryforward complies with the normalization requirements



Situation presented

Many utilities have incurred net operating losses (NOLs) in recent years due to bonus depreciation, favorable section 481(a) adjustments, or general economic conditions. The proper treatment of the resulting NOL carryforward under the normalization requirements has been the subject of numerous ratemaking proceedings.

On May 2, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling (PLR) 201418024 regarding the treatment of deferred tax assets (DTAs) for NOL carryforwards under the deferred tax normalization requirements of Treas. Reg. § 1.167(1)-1(h)(1)(iii). PLR 201418024 held that not including the NOL carryforward DTA in rate base, the methodology advocated by the public utility commission, complied with the normalization requirements in a specific circumstance.

On September 5, 2014, the IRS released PLR 201436037 and PLR 201436038, holding that failure to take into account the portion of an NOL carryforward that is attributable to accelerated depreciation in calculating the amount of a deferred tax liability (DTL) in the computation of rate base would be inconsistent with the normalization requirements and further, that any method for determining the portion of the NOL carryforward attributable to

accelerated depreciation other than the “with and without” method would be inconsistent with the normalization requirements. On September 19, 2014, the IRS released PLR 201438003 providing guidance consistent with the other two rulings issued in September. The methodologies held to comply with the normalization requirements in the more recent rulings were the methodologies advocated by the utilities.

Issue

The methodology that was held to comply with the normalization requirements in PLR 201418024 results in a lower revenue requirement than (1) the alternatives advocated by and approved for many utilities in their rate cases and (2) the approaches held to comply with the normalization requirements in the limited number of NOL-related PLRs released in prior years. This ruling may create regulatory risk in pending and future rate cases for other utilities with NOL carryforwards.

Utilities may need to demonstrate that the rationale underlying the methodology in PLR 201418024 is inapplicable in their factual situations if not universally arguing that it simply is an inappropriate manner of analyzing the recovery of regulatory tax expense, notwithstanding the holdings of the recent three rulings

that did not indicate that the factors or rationale of PLR 201418024 are relevant in applying the normalization requirements for NOL carryforwards.

Background

Treas. Reg. § 1.167(1)-1(h)(1)(iii) provides that if an NOL carryforward would not have arisen (or increased), but for the use of accelerated tax depreciation, 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. This rule recognizes that depreciation-related DTLs are interest-free loans from the government extended via the reduction of current tax liability due to the use of accelerated tax depreciation, and should not reduce the rate base (or, depending on the ratemaking mechanics used by the regulator, reduce the weighted-average cost of capital) unless the depreciation-related DTLs result in a reduction of cash taxes (i.e., serve as a source of funding). This tax rule is consistent with the economics of ratemaking, but is not as prescriptive as most of the deferred tax normalization requirements and does not provide examples of specific methodologies that comply with or violate the rules. Instead, the rule effectively directs utilities to obtain private letter rulings to determine whether their public utility commissions' ratemaking treatments of depreciation-related DTLs, while in an NOL carryforward position, comply with the normalization requirements.

Prior to the 2014 ruling, the IRS had issued one PLR regarding the application of the normalization rules to NOL carryforwards and two PLRs regarding the application of the normalization rules to NOL carrybacks. The three rulings addressed fact patterns involving carryovers to tax years with different statutory tax rates than the tax rates in effect in the years the NOLs were generated, a dynamic not present in rate cases in recent years.

In PLR 8818040, the IRS held that the regulations provide that the amount of deferred taxes subject to the normalization rules in a year an NOL is generated is computed using a "with-and-without" methodology (i.e., deferred taxes equal the excess of taxes due without accelerated depreciation over the taxes due with accelerated depreciation) and using the tax rate effective for the year the tax deferral is realized. The net effect of this accounting in the NOL years was to record no deferred taxes applicable to the amount of accelerated depreciation that produced no current tax savings (i.e., that caused or increased the NOL carryforward). The IRS further ruled that the DTL should not be recorded for ratemaking purposes until 1987, the year in which the utility benefitted from the NOL attributable to accelerated depreciation, and at

the tax rate effective for 1987 (i.e., 39.95 % rather than the 46% tax rate effective for 1985 and 1986, the years the NOLs were generated). The taxpayers did not request guidance on alternative methodologies and the ruling did not address the proration methodology that was analyzed in the 1989 and 1993 rulings summarized below.

In PLR 8903080, the utility incurred an NOL in a tax year with a tax rate of 39.95%, estimated for ratemaking purposes that it would incur an NOL in a tax year with a 34% rate and carried back the NOLs to tax years with tax rates of 46% for purposes of determining ratemaking deferred taxes. For each NOL year, the utility recorded a total tax provision (i.e., sum of the current and deferred tax provisions) at the tax rate in effect for the year in which each NOL was generated (i.e., 39.95% or 34%, respectively). The current tax benefits of the years the NOLs were generated were measured at the 46% tax rates applicable to the years to which the NOL carrybacks were deducted. In each year an NOL was generated, the deferred tax expense attributable to the book-tax timing differences was recorded at a tax rate in excess of the statutory tax rates in effect for the years the NOLs were generated (as well as in excess of the enacted tax rates of the future tax years when the timing differences were expected to reverse). The tax rate differential as a result of the NOL carrybacks to the higher rate tax year was allocated pro rata to all timing items for the years the NOLs were generated. The IRS held that recording a total tax provision at the current year's statutory tax rate for each year an NOL was generated is appropriate and is consistent with the normalization requirements of Treas. Reg. § 1.167(1)-1(h)(1)(iii). This ruling also indicated that the methodology complied with the normalization requirements applicable to excess deferred income taxes under section 203(e) of the Tax Reform Act of 1986. The methodology described above was the only approach analyzed in the ruling.

In PLR 9336010, the utility incurred an NOL in a tax year with a 34% tax rate and carried back the loss to a year with a 46% tax rate. For financial reporting purposes, the utility recorded deferred taxes for all timing differences originating in the year the NOL was generated at the 34% tax rate applicable to such year (and future years). Commission staff recommended that for ratemaking purposes deferred taxes be recorded at the 46% tax rate applicable in the carryback years and that an excess DTL reducing rate base be created. The commission adopted the staff's recommendation and ordered the utility to seek a private letter ruling to determine the amortization method and period related to the excess tax reserve resulting from the interaction of the reduction in corporate

income tax rates and the NOL carryback. The utility and commission staff asserted that none of the excess tax reserve resulting from the NOL carryback resulted from the use of accelerated depreciation. The IRS disagreed and concluded that the taxpayer had not shown which particular items caused the NOL and, thus, the appropriate methodology to allocate the excess tax reserve among timing differences originating in the year the NOL was generated is a pro rata allocation to all timing differences. The IRS held that a portion of the excess deferred tax reserve resulting from the NOL carryback is attributable to the timing difference for accelerated depreciation and that only this portion of the excess tax reserve is subject to the normalization requirements for excess deferred taxes. There was no detailed discussion on exactly how the pro rata allocation was to be effectuated by the taxpayer in this ruling.

The taxpayer in PLR 201418024 incurred taxable losses in excess of taxable income over a multiyear period and as of its test year had an NOL carryforward and a minimum tax credit (MTC) carryforward (attributable to the rule limiting utilization of alternative minimum tax NOL carryforwards to 90% of alternative minimum taxable income). The amount of accelerated depreciation claimed in the two loss years exceeded the amount of NOLs incurred in those years. The utility filed a general rate case with plant-based DTL balances reduced by the amounts of tax not deferred due to the NOL and MTC carryforwards. The commission issued an order with rates based on DTL balances unreduced by the effects of the carryforwards. In its analysis, the IRS stated that there is little guidance on exactly how an NOL or MTC carryforward must be taken into account in calculating DTLs pursuant to the normalization requirements, but it is clear that both must be taken into account for ratemaking purposes. The ruling indicates that the commission has stated that in setting rates it included a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility had an NOL or MTC carryforward. This approach is described as allowing a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOL and MTC carryforwards. The IRS accepted these commission assertions as true for purposes of the ruling, did not conclude that the commission had actually set rates in accordance with the assertions, and indicated that the assertions are subject to verification on audit. The IRS held that reduction of rate base by the full amount of the DTL account without regard to the balances of the NOL and MTC carryforward accounts was consistent with the normalization requirements because the commission

already took the carryforwards into account in setting rates.

The taxpayer and its consolidated group in PLR 201436037 incurred or expected to incur NOLs resulting in NOL carryforwards. The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward. Other approaches were proposed by other rate case participants, including a proposal to reduce regulatory tax expense by the amount of the DTA determined to be attributable to accelerated depreciation. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements. Further, any reduction to tax expense included in cost of service to reflect the tax benefit of an NOL carryforward would be inconsistent with the normalization requirements because such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to ratepayers even though the taxpayer had yet to realize the benefits.

Similarly, the taxpayer and its consolidated group in PLR 201436038 incurred or expected to incur NOLs resulting in NOL carryforwards. The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward. Other approaches were proposed by other rate case participants. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that

the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements.

The utility subsidiary in PLR 201438003 forecasted that it would incur an NOL resulting in an NOL carryforward in its test period. The utility reduced its DTL used to reduce rate base by the amount of the DTA for the NOL carryforward. The utility's commission issued an order holding that it was inappropriate to include the DTA for the NOL carryforward in rate base, but stating that it intended to comply with the normalization requirements and that it would allow the utility to seek an adjustment to rates if it obtains a private letter ruling affirming the utility's position that failure to reduce its rate base offset for depreciation-related DTL by the DTA attributable to the NOL carryforward would be inconsistent with the normalization requirements. The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods. The IRS stated that the with-or-without methodology employed by the utility provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation. The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balance unreduced by the balance of the DTA for the NOL carryforward would be inconsistent with the normalization requirements. The IRS also ruled that use of a balance for the portion of the DTA for the NOL carryforward attributable to accelerated depreciation that is less than the amount computed on a with-and-without basis would be inconsistent with the normalization requirements. The IRS also held that assignment of a zero rate of return to the balance of the DTA for the NOL carryforward attributable to accelerated depreciation

would be inconsistent with the normalization requirements.

Implications

The economic and regulatory debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking involves acknowledgment that recorded DTLs resulting from enacted tax incentives, such as accelerated depreciation intended to stimulate the economy, essentially represent interest-free loans from the government to taxpayers, regardless of the industry of the taxpayer or how the taxpayer sets its prices. The interest-free loan only occurs if or to the extent the corresponding deductions result in reduction (deferral) of tax payments to the government. This does not occur when the deductions for accelerated depreciation result in or contribute to an NOL carryforward.

The normalization debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking may involve:

- Whether the full amount of the depreciation-related DTL may reduce rate base despite the existence of an NOL carryforward (i.e., whether the DTA for the portion of an NOL carryforward attributable to accelerated depreciation must be included in rate base);
- How to compute the depreciation-related portion of a DTA for an NOL carryforward; and
- Consideration of alternative approaches to reduce the revenue requirement when an NOL carryforward exists and some or all of the DTA for the NOL carryforward is included in rate base.

The IRS has exercised the discretion granted to it by the normalization regulations to assess whether the specific methodologies arising in rate cases and presented in five private letter ruling requests involving NOL carryforwards comply with the normalization requirements. The alternatives and arguments of the parties to the rate proceedings have varied in the private letter rulings issued in this area.

In PLR 201418024, the only private letter ruling on these matters resulting from a ruling request that did not seek guidance regarding use of the with-or-without methodology, the IRS instead considered a perspective presented that focused on whether the utility had recovered through rates charged amounts that compensated it for deferred tax expense attributable to depreciation deductions that had not yet resulted in savings of cash taxes in the current year or a carryback year. Whether this factor is relevant is questionable and how to determine whether this condition exists is challenging. Without explaining how to determine whether this ratemaking condition exists, the IRS held in PLR 201418024 that there is a ratemaking approach that

complies with the deferred tax normalization requirements yet permits not reducing depreciation-related DTLs due to the existence of an NOL or MTC carryforward.

In light of the analysis and holding of PLR 201418024, utilities may need to evaluate whether they have recovered depreciation-related deferred tax expense from ratepayers when NOL carryforwards have been incurred or are expected to recover depreciation-related deferred taxes from ratepayers when NOL carryforwards are forecasted. Utilities without tax adjustment clauses (i.e., “trackers”) or without true-up mechanisms with regard to allowed earnings may have difficulty establishing whether or not they have actually recovered the amount of income taxes inherent in their revenue requirement or the portions of their actual revenues attributable to regulatory income tax expense. Any such analysis should also address whether it is possible or appropriate to evaluate whether a single component of regulatory tax expense (i.e., depreciation-related deferred tax expense) has been recovered through rates without regard to the other components of the tax provision (e.g., other components of the deferred tax provision, the current tax provision, investment tax credit (ITC) amortization). In analyzing the application of the facts and assumptions of PLR 201418024 to their rate situations, utilities will likely need to assess whether the income tax components of their revenue requirements in their most recent rate cases (or their actual revenues during the years NOLs were generated) are determined with reference to allowed equity returns, actual equity returns, book-tax differences, or other factors. It would also be worthy to note whether the depreciation-related portion of deferred tax expense exceeds the total or net tax provision (in light of the current tax benefit likely recorded in an NOL year).

The factor analyzed in PLR 201418024 was not mentioned in the other four NOL carryforward normalization letter rulings. In the other four private letter rulings, the IRS

consistently held that the maximum depreciation-related DTL that is allowed to reduce rate base must consider the existence of an NOL carryforward and that the depreciation-related portion of the DTA for the NOL carryforward included in rate base must be computed with reference to a with-or-without approach (sometimes referred to as a with-and-without approach in the rulings).

The IRS has also ruled that two alternative approaches proposed by parties to rate proceedings seeking to reduce revenue requirements when an NOL carryforward exists would violate the normalization requirements. These alternatives were proposed to mitigate or eliminate the effect of inclusion of a DTA related to an NOL carryforward in rate base reduction of recoverable tax expense by an amount equal to the deferred tax benefit associated with the DTA, and treatment of the DTA as zero-cost capital. Utilities should continue to assert economic, ratemaking, and tax normalization defenses against similar assertions that aim to circumvent the effects of the normalization requirements.

Lastly, it should be noted that there are a number of other pending ruling requests regarding the application of the normalization requirements to NOL carryforwards that will afford the IRS additional opportunities to provide guidance on this important issue.

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