DOCKET NO. _______

APPLICATION OF SOUTHWESTERN	**§**	**PUBLIC UTILITY COMMISSION**
PUBLIC SERVICE COMPANY FOR	**§**	
AUTHORITY TO CHANGE RATES	**§**	**OF TEXAS**

DIRECT TESTIMONY
of
NAOMI KOCH

on behalf of

SOUTHWESTERN PUBLIC SERVICE COMPANY

(*Filename:* KochRRDirect.doc)

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GLOSSARY OF ACRONYMS AND DEFINED TERMS

Acronym/Defined Term	**Meaning**
ADIT	Accumulated Deferred Income Taxes
Commission	Public Utility Commission of Texas
CWIP	Construction Work in Progress
FERC	Federal Energy Regulatory Commission
GAAP	Generally Accepted Accounting Principles
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ITC	Investment Tax Credit
kWh	Kilowatt hour
NOL	Net Operating Loss
NOL carryforward	NOL-related deferred tax asset
NSPM	Northern States Power Company, a Minnesota corporation
PLR	Private Letter Ruling
PTC	Production Tax Credit
PURA	Public Utility Regulatory Act
R&E	Research and Experimentation
RFP	Rate Filing Package
SPS	Southwestern Public Service Company, a New Mexico corporation
TCJA	Public Law No. 115-97, commonly referred to as the federal Tax Cuts and Jobs Act
Test Year	October 1, 2019 through September 30, 2020

Acronym/Defined Term	Meaning
Total Company	Total SPS (before jurisdictional allocators)
Treasury	United States Department of the Treasury
Update Period	October 1, 2020 through December 31, 2020
Updated Test Year	January 1, 2020 through December 31, 2020
Xcel Energy	Xcel Energy Inc.
XES	Xcel Energy Services Inc.

LIST OF ATTACHMENTS

Attachment	Description
NK-RR-1	Internal Revenue Code § 168 and 26 C.F.R. § 1.167(l)-1 (*Non-native format*)
NK-RR-2	Private Letter Ruling 201438003 (*Non-native format*)
NK-RR-3	Private Letter Ruling 201436038 (*Non-native format*)
NK-RR-4	Private Letter Ruling 201436037 (*Non-native format*)
NK-RR-5	SPS Property Tax Calculation (*Filename:* Attachment NK-RR-5.xlsx)

DIRECT TESTIMONY
OF
NAOMI KOCH

I. WITNESS IDENTIFICATION AND QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Naomi Koch. My business address is 414 Nicollet Mall, Minneapolis, Minnesota 55401.

Q. On whose behalf are you testifying in this proceeding?

A. I am filing testimony on behalf of Southwestern Public Service Company, a New Mexico corporation ("SPS") and wholly-owned electric utility subsidiary of Xcel Energy Inc. ("Xcel Energy").

Q. By whom are you employed and in what position?

A. I am employed by Xcel Energy Services Inc. ("XES"), the service company subsidiary of Xcel Energy, as Director, Tax Reporting.

Q. Please briefly describe your duties as Director, Tax Reporting.

A. I oversee federal and state income tax compliance and accounting, as well as sales, use and property tax compliance and accounting, for all Xcel Energy group companies.

Q. Please describe your educational background.

A. I earned a Bachelor of Science degree from the University of Minnesota and a Masters of Business Taxation degree from the University of Minnesota.

Q. What is your professional experience?

A. I have over twenty years of corporate tax experience with XES and the former Northern States Power Company, a Minnesota corporation ("NSPM"). I joined

NSPM in 1999 in Tax Services. Through this experience, I have become familiar with various provisions of the Internal Revenue Code ("IRC") and Internal Revenue Service ("IRS") regulations (also referred to as rules) that affect public utilities. I also have become familiar with various state laws, utility commission rules, and court cases that relate to the treatment and calculation of tax expenses, including income tax, for ratemaking and utility regulatory purposes, including those of Texas.

Q. Have you taken courses related to public utilities?

A. Yes. I have taken several courses related to accounting and taxation of public utilities offered by the Edison Electric Institute, the American Gas Association, Deloitte & Touche, PricewaterhouseCoopers, and Arthur Andersen.

Q. Are you a member of any professional organizations?

A. Yes. I am a member of the Tax Executives Institute, an association of in-house business tax professionals worldwide.

Q. Have you filed testimony before any regulatory authorities?

A. Yes. I have filed testimony before the Public Utility Commission of Texas ("Commission") in Docket Nos. 45524, 47527, and 49831, SPS's last three base rate proceedings, regarding bonus depreciation, income tax issues, accumulated deferred income taxes ("ADIT"), the Tax Cuts and Jobs Act ("TCJA"), and property taxes. I have also filed testimony on those same issues before the New Mexico Public Regulation Commission and before the Public Utilities Commission of the State of Colorado.

II. ASSIGNMENT AND SUMMARY OF CONCLUSIONS

Q. What is your assignment in this testimony?

A. I have several assignments in this testimony. First, I support the amounts of federal and state income tax expense included in SPS's cost of service and the amount of ADIT reflected in SPS's rate base.

Second, I describe the normalization rules prescribed by the IRC and United States Department of the Treasury ("Treasury") Regulations, and I explain that SPS has calculated its rates consistent with those normalization requirements.

Third, I provide the high-level impacts of the TCJA, which is the federal tax reform law that was passed in December 2017 that lowered the federal income tax rate and made several other changes to deductions previously available to SPS.

Fourth, I quantify the amount of property taxes in the Test Year[1] and the Update Period[2], and I explain the adjustments to property taxes.

Finally, I sponsor or co-sponsor many of the G-7 schedules included in SPS's rate filing package ("RFP"), which address federal income tax, and I sponsor the two G-9 schedules, which address property tax. I will discuss those schedules in more detail in the next section of my testimony. I also sponsor or co-sponsor the portions of the Executive Summary that contain information from the schedules that I sponsor.

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[1] Test Year is the period October 1, 2019 through September 30, 2020.

[2] Update Period is the period October 1, 2020 through December 31, 2020.

Q. Please summarize the conclusions and recommendations in your testimony.

A. **<u>Income Taxes</u>** – Along with SPS witness Mark P. Moeller, I assisted SPS witness Stephanie N. Niemi in calculating the income tax expense and the ADIT balance included in the cost of service and rate base, respectively. The accounting principles underlying both the requested amount of income tax expense and the ADIT balance reflected in rate base comply with Generally Accepted Accounting Principles ("GAAP"), the Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts (which is used by the Commission), and Commission precedent. The requested income taxes included in the cost of service and the amount of ADIT reflected in rate base have been calculated on a stand-alone basis, which is also consistent with Commission precedent.

The requested income taxes included in the cost of service and the amount of ADIT reflected in rate base comply with the normalization requirements of the IRC and Treasury Regulations. SPS has complied with the normalization rules because failure to do so would ultimately harm SPS's customers by increasing the amount of rate base on which customers pay a return.

As discussed later in my testimony, a net operating loss ("NOL") occurs when a company's allowable tax deductions exceed its taxable income, resulting in negative taxable income. SPS's use of accelerated depreciation has resulted in SPS experiencing NOLs in previous years. SPS did not experience an NOL during the Test Year or Update Period, but the NOLs carried forward from prior years have created a deferred tax asset that SPS has used to reduce taxable income in the Updated Test Year.

Although SPS utilizes accelerated depreciation in its tax returns, for purposes of setting rates, SPS's federal income tax expense must be calculated as though SPS had used straight-line depreciation.[3] Calculating the federal income tax expense included in SPS's rates using accelerated depreciation would violate IRS normalization rules, which would disqualify SPS from using accelerated depreciation and would increase the rate base on which SPS's customers pay a return.

In addition, SPS's ADIT balance should be offset by the NOL-related deferred tax asset (which is typically referred to as an "NOL carryforward") that results from SPS's inability to currently benefit from all of the accelerated depreciation deductions it claimed in the Test Year and Update Period. Failure to offset the tax-affected NOL carryforward against the ADIT balance would also give rise to a normalization violation, with the same adverse consequences discussed earlier.

I also discuss the research and experimentation ("R&E") credit included in the cost of service. SPS has also included in rate base a deferred tax asset associated with the R&E credit.

I also recommend that the Commission approve SPS's request to recover a jurisdictional share of SPS's state income taxes and its Texas jurisdictional share of the Texas gross margin tax, in its cost of service.

Property Taxes – I recommend that the Commission approve SPS's requested property tax amount, including the property tax adjustments discussed in my

[3] In contrast to accelerated depreciation, straight-line depreciation recovers the cost of an asset in equal amounts each year over the asset's expected productive life. Straight-line depreciation is used for financial accounting and regulatory purposes.

testimony. At this time, SPS is requesting $72,076,000 (total company) for property taxes. SPS has adjusted its estimated amount of property tax expense to reflect property taxes associated with construction work in progress ("CWIP") by removing $896,000 (total company) from property tax expense and adding that amount to rate base. SPS placed that amount in rate base to reflect the Commission's ruling in Docket No. 43695 that property taxes on plant that have not yet been placed in service be capitalized.[4]

Q. Will your testimony be updated for actual costs incurred in the three months following the Test Year, October through December 2020, the Update Period?

A. Yes. A portion of my testimony will be updated. As discussed by SPS witness William A. Grant, SPS will file an update 45 days after SPS files this application. The update will include actual costs incurred to replace the estimates provided in the application for the period of October 1, 2020 through December 31, 2020, referred to as the "Update Period."

Q. Are Attachments NK-RR-1 through NK-RR-4 true and correct copies of the documents that you describe in your testimony?

A. Yes.

Q. Was Attachment NK-RR-5 prepared by you or under your direct supervision and control?

A. Yes.

[4] *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 43695, Order on Rehearing at Finding of Fact 230 (Feb. 23, 2016).

Q. Were the RFP schedules and the portions of the Executive Summary to the RFP that you are sponsoring or co-sponsoring prepared by you or under your supervision and control?

A. Yes.

Q. Do you incorporate the RFP schedules and the portion of the Executive Summary shown to be sponsored or co-sponsored by you into your testimony?

A. Yes.

III. SCHEDULES SPONSORED

Q. You testified earlier that you sponsor the G-7 schedules, which address income tax. Please summarize the G-7 schedules and explain whether they are applicable in this case.

A. I sponsor the following G-7 schedules:

- Schedule G-7.1 includes a reconciliation of book net income and taxable net income for the Test Year and for the most recent year for which a tax return was filed. I co-sponsor this schedule along with Mr. Moeller.
- Schedule G-7.1a includes a reconciliation detailing the timing differences and other items that would produce an income tax at a rate differing from the statutory rate. I co-sponsor this schedule with Mr. Moeller.
- Schedules G-7.3, G-7.3a, and G-7.3b address consolidated tax savings adjustments. Because of a 2013 amendment to Section 36.060 of the Public Utility Regulatory Act ("PURA"), SPS is no longer subject to a consolidated tax savings adjustment, and therefore these schedules are not applicable to SPS.
- Schedule G-7.4 provides the year-end ADIT balances for the Test Year, including the book balance, the requested adjustments to the balances, and the resulting adjusted ADIT balances. I co-sponsor this schedule with Ms. Niemi and Mr. Moeller.
- Schedule G-7.4a includes a description of the nature of each timing difference listed in Schedule G-7.4. I co-sponsor this schedule with Mr. Moeller.
- Schedule G-7.4b provides supporting explanations and detailed calculations for each adjustment to the Test Year year-end balances in Schedule G-7.4. I co-sponsor this schedule with Ms. Niemi and Mr. Moeller.
- Schedule G-7.4c provides ADIT balances and Investment Tax Credit ("ITC") balances at year-end related to additions to new generating plant in service and any plant adjustments to the year-end balances. I co-sponsor this schedule with Mr. Moeller.
- Schedule G-7.4d provides detail related to ADIT associated with rate-case expenses. I co-sponsor this schedule with Ms. Niemi.
- Schedules G-7.5 through G-7.5e address ITCs. SPS did not generate or utilize any ITCs during the Test Year. All ITCs included in the schedules are

amortizations from prior years in which SPS generated or utilized ITCs. I co-sponsor these schedules with Mr. Moeller.

- Schedule G-7.6 provides an analysis of income tax calculated using Tax Method 2. I co-sponsor this schedule with Mr. Moeller and Ms. Niemi.
- Schedule G-7.6a provides support for the Total Deferred Income Taxes found on Schedule G-7.6. I co-sponsor this schedule with Mr. Moeller and Ms. Niemi.
- Schedule G-7.8 provides an analysis of income tax calculated using Tax Method 1. I co-sponsor this schedule with Mr. Moeller and Ms. Niemi.
- Schedule G-7.10 is not applicable to SPS because it does not have accounting order (cost) deferrals. I co-sponsor this schedule with Mr. Moeller.
- Schedules G-7.12 and G-7.12a are not applicable because SPS is not requesting a rate moderation plan.
- Schedule G-7.13 contains a list of testimony addressing income taxes and ADIT. I co-sponsor this schedule with Mr. Moeller and Ms. Niemi.
- Schedule G-7.13a contains a discussion of SPS's history of normalization.
- Schedule G-7.13b lists the tax elections made since the test year in SPS's prior base rate case.
- Schedule G-7.13c explains that there have been no changes to SPS's accounting for deferred income tax since the end of the test year in SPS's last base rate case. I co-sponsor this schedule with Mr. Moeller.
- Schedule G-7.13d explains SPS's IRS audit status.
- Schedule G-7.13e explains that SPS has not requested or received any private letter rulings since its last base rate case.
- Schedule G-7.13f describes SPS's method for accounting for ADIT related to NOL carryforwards.

Q. Please summarize the Schedule G-9 schedules that you sponsor or co-sponsor.

A. I co-sponsor Schedule G-9, which lists and explains all taxes other than income taxes, including property taxes and gross receipts taxes. Ms. Niemi co-sponsors this schedule.

I also sponsor Schedule G-9.1, which lists the ad valorem taxes assessed, penalties paid, and discounts taken for the three calendar years before the Test Year. The schedule also contains the plant balances at the beginning of each of those three years.

IV. ACCOUNTING FOR INCOME TAXES

Q. What topics do you discuss in this section of your testimony?

A. I discuss the calculation of SPS's income tax expense included in the cost of service. I also explain how the ADIT balance is created.

A. Calculation of Income Taxes and ADIT

Q. Did you participate in the calculation of the income tax expense and ADIT balance included in SPS's cost of service?

A. Yes. Mr. Moeller and I provided information to and assisted Ms. Niemi in the calculation of the income tax expense and ADIT balances included in SPS's cost of service. Along with Mr. Moeller, I ensured that the tax calculations were correct and did not violate Treasury normalization rules, which I will discuss in more detail later in my testimony.

Q. What standards did you follow when calculating the income tax and ADIT balances?

A. I followed GAAP, the FERC Uniform System of Accounts, the IRC, including associated Treasury Regulations and IRS guidance, the PURA, and Texas precedent concerning the treatment of taxes in a utility's cost of service.

Q. Please describe the general process used to calculate SPS's income tax expense for ratemaking purposes.

A. SPS calculates its income tax expense through a multi-step process:

1. SPS determines its taxable income by first summing its operating expenses, including interest payments and straight-line book depreciation expense, and then subtracting those operating expenses from total revenues to arrive at the net income before income taxes.
2. SPS next calculates the additions to or deductions from net income that result from temporary and permanent tax differences. Those amounts are then

added to the net income calculated above to arrive at federal taxable income before state income taxes.

3. State income taxes are calculated similarly. Net income is adjusted for temporary and permanent additions and deductions to arrive at state taxable income. This income is then allocated to the respective state using an apportionment percentage (each state calculates apportionment slightly different, but apportionment percentages are generally based on a ratio of the company's sales, property, and/or payroll in a state to its sales, property, and/or payroll everywhere). The apportioned state taxable income is then multiplied by the applicable state tax rate to arrive at the current state income tax, which is then reduced by state tax credits, as applicable.

4. The state income taxes are then added to or subtracted from the taxable income before state taxes to arrive at the federal taxable income, and the net of that amount is multiplied by the federal income tax rate. The product of that calculation is the current federal income tax.

5. If the taxable income referenced above is negative, it indicates an NOL that can be carried forward (or backward) to offset future taxable income.

6. To arrive at the total income tax expense, SPS adds federal and state current income tax expense, federal and state deferred income tax expense, R&E credits, and historical ITCs.

Q. In the second step of that process, you refer to "temporary differences." Please explain how temporary differences arise.

A. Generally speaking, temporary differences arise when SPS collects tax expense from customers in one period, but pays the associated tax expense to the IRS in a different period. The most common example involves depreciation expense, which is typically accelerated for tax purposes, but not for ratemaking purposes. The use of accelerated depreciation reduces SPS's taxable income, which defers taxes until a later time. For purposes of setting rates, however, SPS calculates its tax expense as though it had used a straight-line book depreciation method. Thus, SPS recovers income tax expense from customers on a "normalized" basis, which results in SPS collecting income tax expense that is not paid to the IRS until a later time. That leads to the ADIT balance that I referenced earlier in my testimony.

Q. Please provide an example of how the ADIT balance accrues.

A. Suppose a utility had taxable income of $1,000 and a federal income tax rate of 21%. In the absence of any other factors, the utility would collect $210 from its customers as federal income tax expense, and it would pay the IRS $210 in federal income taxes.

Now suppose the same facts, except that accelerated depreciation has given the utility enough depreciation expense to offset the entire $1,000 of taxable income. The utility still collects the $210 from its customers because of normalization rules, but it does not have to pay that amount to the IRS until some later date when the utility has taxable income. The utility must record that $210 as deferred income tax expense, or ADIT.

Q. Does SPS experience temporary differences in any context other than accelerated depreciation?

A. Yes. SPS experiences a number of non-plant temporary differences, such as costs associated with pension expense, fuel expense, and many other types of expenses or revenues. Some of those temporary differences result in deferred tax assets, and some result in deferred tax liabilities. The net cumulative amount represents SPS's ADIT balance.

Q. How is the ADIT balance reflected in rate base?

A. The ADIT balance will eventually have to be paid to the IRS and corresponding state agencies because accelerated depreciation creates only a temporary timing difference. That is why the ADIT balance is considered to be a deferral of tax liability, not a reduction of tax liability. Until the ADIT balance is paid back to the IRS and corresponding state agencies, it is used as a dollar-for-dollar reduction of rate base. In effect, the utility is receiving an interest-free loan from the federal government in the form of the ADIT balance, and, therefore, it does not need a return on an equivalent amount of rate base.

B. Federal Income Tax Credits

Q. What is the federal R&E credit referenced in step 6 above?

A. The federal R&E credit is a credit available to taxpayers who engage in qualifying R&E activities. SPS completes an annual study to determine which costs are eligible for the federal R&E credit. These costs include certain wages, supplies, and contract research expenses. The credit is non-refundable, which means that a taxpayer must have a tax liability to use the credit. When there is insufficient tax liability to fully use the credit, the credit may either be carried back one year or carried forward up to twenty years.

Q. Did SPS include a federal R&E credit in its Test Year cost of service?

A. Yes. The Test Year cost of service includes $2,035,699, total company, of federal R&E credits.

Q. What is an example of SPS's R&E activity?

A. A recent example is SPS's research and experimentation related to the construction engineering for the Hale Wind Project.

Q. Please discuss production tax credits and their calculation.

A. The production tax credit ("PTC") is an inflation-adjusted per-kilowatt-hour ("kWh") tax credit for electricity generated and sold by the taxpayer during the taxable year. The PTC is available for 10 years after the facility is placed in service. As of the end of the Test Year, the PTC rate is 2.5 cents per kWh.

Q. Is SPS currently earning any PTCs?

A. Yes. SPS started earning a PTC from the Hale Wind Project in 2019 and from the Sagamore Wind Project at the end of 2020.

Q. How are the PTCs generated by the Hale and Sagamore Wind Projects being shared with customers?

A. Consistent with the Commission's Order in Docket No. 46936, for the first 60 days of commercial operation, SPS will retain the Texas retail portion of the PTCs for each project. After the first 60 days of commercial operation, SPS will credit Texas retail customers with the Texas retail portion of the PTCs.

Q. What happens if SPS has insufficient tax liability to utilize the PTC?

A. SPS may either carry back the PTC one year or carry it forward up to twenty years. Any unused PTC is carried forward as a deferred tax asset.

Q. Is SPS including a PTC deferred tax asset in this case?

A. Yes. The Hale Wind Project began earning PTCs in June 2019 and the Sagamore Wind Project began earning PTCs on December 31, 2020. Consistent with the requirements in the Commission's Order in Docket No. 46936, SPS did not include a PTC deferred tax asset in rate base for the PTCs that SPS retains during the first 60 days of commercial operation, but has for the unutilized PTCs after each 60-day period.

Q. Are any PTCs included in SPS's Test Year cost of service?

A. No. The PTCs generated by the Hale Wind Project, and later in 2020 by the Sagamore Wind Project, are being shared with customers as part of the fuel cost recovery factor, not as a reduction to income tax expense. Please refer to the Direct

Testimony of SPS witness William A. Grant for additional discussion of SPS's PTC sharing.

C. Federal and State Income Tax Rates

Q. Are you using the 34% tax rate provided in the Electric Utility Rate Filing Package instructions?

A. No.

Q. What income tax rate are you using?

A. SPS is using the required 21% federal corporate income tax rate and a 1.2562% state composite income tax rate. SPS's method of computing these tax rates is consistent with PURA § 36.060 and the method used in Docket Nos. 47527 and 49831.[5]

Q. Why are these rates appropriate?

A. The 21% tax rate is the appropriate rate for federal corporate income taxes because that was the rate in effect during the Test Year. Thus, that is the rate that applied to SPS during the Test Year and Update Period. In addition, including taxes for the 1.2562% state composite income tax rate represents SPS's cost of doing business.

Q. How were these income tax rates calculated?

A. For the federal income tax rate, SPS is using the corporate income tax rate currently in effect, which is 21%. For the state income tax rate, SPS has calculated a composite rate based upon the state income tax rates for the states in which SPS has presence. For state income tax purposes, presence is generally driven by property or payroll, and this presence generally obligates SPS to pay income taxes in those

[5] PURA § 36.060(a) provides that a utility's income tax expense "shall be computed using the statutory income tax rates."

states. These states include Kansas, Michigan, New Mexico, and Oklahoma.[6] SPS multiplies each state's corporate income tax rate by SPS's apportionment factor for the associated taxing jurisdiction. The apportionment factor is determined annually when SPS files its state income tax returns. SPS then adjusts the apportioned state income tax rate to account for the federal income tax benefit resulting from each state's income tax expense. All of SPS's apportioned state income tax rates are then added together to arrive at SPS's composite state income tax rate.

For example, Kansas's corporate income tax rate is 7%, and 0.3219% of SPS's total income was apportioned to Kansas in SPS's 2019 income tax return. The product of these numbers results in an apportioned tax rate of 0.0225% (i.e., 7% x 0.3219% = 0.0225%). The state apportioned tax rate is then reduced by the federal corporate rate of 21% to reflect the federal deductibility of state income taxes. The resulting rate, 0.0178%, is the apportioned state income tax rate for Kansas (i.e. 0.0225% x (1 - 21%) = 0.0178%).

SPS's federal plus composite state income tax rate can be reconciled as follows:

[6] Although SPS had payroll (i.e., "presence") in Michigan in 2019, Michigan does not include payroll in its apportionment calculations. For this reason, the payroll did not result in an apportionment factor in the 2019 Michigan return, which is the most recently filed tax return. Therefore, SPS did not include a Michigan income tax rate in its composite income tax rate.

Table NK-RR-1
Composite State Income Tax Rate

	A. JURISDICTIONAL TAX RATE in EFFECT at SEPTEMBER 30, 2020	B. STATE APPORTIONMENT per 2019 STATE INC. TAX RETURNS	C. APPORTIONED TAX RATE (columns A x B)	D. FEDERAL DEDUCTION FOR STATE TAXES (column Cx-21%)	E. COMPOSITE INCOME TAX RATE (column C + D)
Federal	21%	*N/A*	21%	*N/A*	21%
Kansas	7.00%	0.3219%	0.0225%	-0.0047%	0.0178%
Michigan	6.00%	0.0000%	0.0000%	0.0000%	0.0000%
New Mexico	5.90%	26.1320%	1.5418%	-0.3238%	1.2180%
Oklahoma	6.00%	0.4292%	0.0258%	-0.0054%	0.0204%
Total State Income Tax Rate		1.1104%			
Total Composite Income Tax Rate					**22.2562%**

Q. Why is SPS including state income taxes for jurisdictions outside of Texas?

A. SPS is including state income taxes for each of its taxing jurisdictions in which it has property or payroll (i.e., employees). As stated above, property and payroll generally cause state presence for state income tax purposes, which obligates SPS to pay income taxes in those jurisdictions. SPS's property and payroll in each of these states are integral to SPS serving its retail customers in Texas. Therefore, SPS is including state income taxes for these other jurisdictions.

Q. Is SPS including any other state income taxes in this rate case?

A. Yes. SPS is also including the Texas Gross Margin Tax. The Texas Gross Margin Tax is not denominated as a state income tax, but it is functionally equivalent to a state income tax, and therefore SPS treats it as an income tax for ratemaking purposes.

Q. What is the Texas Gross Margin Tax?

A. The Texas Gross Margin Tax, which is sometimes referred to as a "franchise tax," is a tax imposed by the State of Texas. The margin tax is assessed at 0.75% of Texas-sourced taxable margin. The taxable margin is computed as the lesser of:

(1) 70% of total revenue; or

(2) total revenue less:

(a) cost of goods sold;

(b) compensation; or

(c) one million dollars.

For SPS, the lower tax has generally resulted from option 2(a). The resulting "margin" is then apportioned to Texas based on the percent of gross receipts the Company earns in the state.

Q. What basis did SPS use to calculate the gross margin tax expense it is seeking to include in its cost of service in this case?

A. SPS calculated the gross margin tax amount included in the cost of service based on three months of the 2019 Texas Franchise Tax Return, which is based on 2018 actual financials, and nine months of the 2020 Texas Franchise Tax Return, which is based on 2019 actual financials. That amount is $2,547,011, net of federal taxes (total company).

Q. Have ADIT and deferred taxes in the cost of service been adjusted for the Gross Margin Tax?

A. Yes. As discussed earlier, SPS's Texas Gross Margin Tax is generally calculated as total revenue less the cost of goods sold. Therefore, Texas deferred taxes are recorded for temporary differences associated with revenue and with the cost of goods sold, including certain types of depreciation. These Texas deferred taxes are included as an adjustment to rate base and as part of the deferred tax expense included in the cost of service.

Q. Are SPS's Texas customers bearing the full burden of SPS's state income taxes?

A. No. SPS's Texas retail customers are getting charged only for their Texas retail jurisdictional share of the total state income tax expense, similar to how Texas customers are only getting charged the Texas retail jurisdictional portion of SPS's federal income tax expense. The Texas retail customer share is assessed using the jurisdictional allocators detailed in the cost of service.

Q. Has SPS incorporated any tax rate changes that might occur in the future?

A. No. SPS is using the federal and state income tax rates in effect at December 31, 2020. It would not be appropriate to incorporate any rate changes resulting from future legislation or tax reform until such changes are enacted and in effect. If and when federal or state income tax rates change, SPS will assess the impact to customers and incorporate the change into this and any future rate filings. Please refer to Mr. Moeller's testimony for additional discussion on this topic.

D. Computation of SPS's Income Taxes on a Stand-Alone Basis

Q. Earlier, you refer to "SPS's stand-alone total income tax expense." What does that mean with regard to SPS's income taxes in this case?

A. The requested income taxes included in the cost of service and the amount of ADIT reflected in rate base have been calculated on a stand-alone basis. This means that SPS's income taxes were calculated as if SPS were a stand-alone company, rather than a subsidiary of a holding company.

Q. How does SPS file its income tax returns with the IRS?

A. The IRC requires SPS to file its income tax return as part of the Xcel Energy Inc. and Affiliates consolidated group. This consolidated return includes SPS's separate company returns as well as those of Xcel Energy's other subsidiary corporations. The IRS consolidated return rules require the taxable incomes and taxable losses of all companies to be combined, and limitations on items like taxable losses, NOLs and tax credits to be determined at a consolidated level, rather than based on each individual company.

Q. If SPS files its income tax returns as part of Xcel Energy consolidated group, why is it appropriate for SPS to use the stand-alone approach for rate making?

A. As discussed above, filing the tax returns as part of a consolidated group means that the other companies in the group impact the other companies' income taxes. Although this may benefit SPS in some years, it can also cost SPS in other years. The stand-alone approach is necessary to ensure that SPS's income taxes are calculated based on its own income and deductions. Therefore, consistent with how other costs are calculated in the cost of service, SPS has consistently used the stand-alone approach to calculate income taxes for rate making. Doing so ensures that Texas customers pay income taxes only for costs incurred in providing service to Texas customers. While I am not a lawyer, I understand that PURA § 36.060 was amended in 2013 to eliminate the requirement that utilities' federal income taxes include a "consolidated tax savings" adjustment. The statute now requires that the income tax calculation for ratemaking purposes be based on a utility's own investments, expenses, and related tax benefits.[7]

[7] PURA § 36.060(a).

Q. What is your recommendation with respect to how the Commission should calculate SPS's income tax expense?

A. In order to protect Texas customers from paying income taxes unrelated to providing service to Texas customers and based on statutory factors and Commission precedent, I recommend that the Commission calculate SPS's income tax expense on a stand-alone basis.

V. THE ROLE OF NORMALIZATION IN UTILITY RATEMAKING

Q. What topics do you discuss in this section of your testimony?

A. I explain the steps that SPS took as part of its federal income tax calculation to avoid violating Treasury normalization rules, and I explain that it is necessary to avoid normalization violations.

A. Normalization and Income Tax Accounting

Q. Please explain what "normalization" means in the context of utility accounting.

A. Normalization refers to a method of accounting in which the tax benefits associated with depreciation of utility assets are spread over the same period that the costs of those assets are recovered from customers. For example, if rates are set based on straight-line book depreciation, the federal income tax expense included in those rates must also be calculated as though the utility used straight-line book depreciation. The difference between the federal income tax expense calculated using accelerated depreciation and the federal income tax expense calculated using straight-line book depreciation is recorded as a deferred tax liability. The cumulative deferred tax liability balance is recorded as ADIT and serves as an offset to rate base.

Q. Earlier you referenced straight-line depreciation. What is straight-line depreciation?

A. Straight-line depreciation is a method of depreciation which recovers the cost of an asset in equal amounts each year over the asset's expected productive life. As is the case in most jurisdictions, the Commission uses straight-line book depreciation for the purpose of computing a utility's depreciation expense in Texas.

Q. What is the source of the tax normalization rules?

A. Tax normalization rules come from various sources including the IRC, Treasury Regulations, and related guidance provided by the IRS, such as Private Letter Rulings ("PLR").

Specifically, Congress mandated normalization for public utilities in IRC § 168(i)(9)-(10), which provides that in order to use a normalization method of accounting with respect to public utility property:

> the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such 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.[8]

The rule requiring a utility to calculate federal income tax expense on a normalized basis is Section 1.167(*l*)-1 of the Treasury Regulations. Copies of the normalization statute and rule are attached to my testimony as Attachment NK-RR-1.

Q. What is your understanding of why Congress enacted the normalization requirements?

A. It is my understanding that Congress's primary purpose in allowing accelerated depreciation was to stimulate investment in capital assets, such as electricity production, transmission, and distribution assets. If a utility were required to immediately pass through all tax benefits resulting from accelerated depreciation using flow-through accounting, utilities would have decreased incentives to invest in the capital assets that give rise to accelerated depreciation. Additionally, using

[8] IRC § 168(i)(9)(A)(i).

flow-through accounting would create intergenerational inequity because current customers would receive a benefit that should be spread over the life of the asset. Accordingly, Congress mandated normalization treatment, which requires that federal income tax expense be calculated for ratemaking purposes as though the utility had depreciated its assets on a straight-line book basis.[9]

Q. Did SPS recognize accelerated depreciation in the calculation of federal income tax expense included in the Test Year cost of service?

A. No. To remain in compliance with the normalization rules, SPS calculated the federal income tax expense included in its cost of service using straight-line book depreciation.

Q. Is a regulatory commission required by law to follow the normalization rules for ratemaking purposes?

A. No. Congress did not directly prohibit regulators from using other methods to set rates, but if a utility were to receive a regulatory order that led to a violation of the normalization rules, both the utility and its customers would be adversely affected. When a normalization violation occurs, the utility is no longer allowed to use accelerated depreciation.[10] In addition, the taxes that have been deferred as a result of the prior accelerated depreciation must be paid to the federal government more quickly than they would be in the absence of the normalization violation. In light of

[9] *Pub. Util. Comm'n v. GTE-SW*, 833 S.W.2d 153, 166 (Tex. App.—Austin 1992) (explaining normalization as follows: "[T]he expense is determined on a straight-line basis for rate-calculation purposes even though the utility determines the expense on an accelerated basis in calculating its actual income-tax liability."), *rev'd in part on other grounds*, 901 S.W.2d 401 (Tex. 1995).

[10] IRC § 168(f)(2); *see also Application of Lone Star Transmission, LLC for Authority to Establish Interim and Final Rates and Tariffs*, Docket No. 40020, Order on Rehearing at Conclusion of Law No. 16 (Feb. 12, 2013) ("A violation of the normalization rules would prevent Lone Star from using accelerated tax depreciation on all of its public utility property.").

the potential loss of accelerated deductions and for other reasons, Texas and virtually all other jurisdictions have adopted the normalization method of tax accounting for rate setting purposes.

Q. How would those penalties affect the utility's customers?

A. Both of those circumstances would reduce the ADIT balance, which would increase the rate base on which customers pay a return. Thus, a normalization violation would likely result in significantly higher rates for utility customers.

Q. What is your recommendation with respect to how the Commission should calculate SPS's income tax expense?

A. Based on the normalization requirements and the adverse consequences that would result if those requirements are not followed, I recommend that the Commission calculate SPS's income tax expense as though SPS had depreciated its assets on a straight-line book basis.

B. Net Operating Losses and Normalization

Q. What is an NOL?

A. An NOL occurs when a company's allowable tax deductions exceed its taxable income, resulting in negative taxable income. One way in which an NOL can arise is through accelerated depreciation. As previously mentioned, the use of accelerated depreciation with normalization rules generally creates a deferred tax liability. And if a utility has negative taxable income as a result of using accelerated depreciation, the utility will also have an NOL. An NOL may be carried forward to reduce taxable income in future periods. For financial reporting purposes, an NOL carryforward is recorded as a deferred tax asset. In effect, an NOL represents the tax value of claimed deductions that did not reduce the current tax liability.

Q. You testified earlier that SPS had an NOL carryforward from prior years. Please explain how that NOL arose.

A. The NOL calculated for tax purposes arose because SPS claimed accelerated depreciation expense over the last several years. The amount of accelerated depreciation expense exceeded the amount of SPS's taxable income in those years. That excess amount represents the NOL carryforward.

Q. For purposes of calculating the ADIT balance for ratemaking purposes, does it matter whether the utility has an NOL?

A. Yes. As previously explained, the ADIT balance reflects a temporary timing difference that occurs only when the utility has the ability to defer taxes that would otherwise be payable to the IRS and corresponding state agencies. If the utility is not deferring any tax liability, there is nothing to add to the ADIT balance.

For financial reporting purposes, SPS adjusts the ADIT balance for the full amount of accelerated depreciation claimed. If some of the deduction led to an NOL, however, SPS records a deferred tax asset that reflects the NOL carryforward. If SPS did not record this deferred tax asset, the ADIT balance would overstate the amount of benefit SPS has actually realized. Therefore, when the full amount of ADIT balance is used to reduce rate base, an adjustment is needed to ensure that rate base is reduced only to the extent the utility was able to defer tax liability. Such an adjustment allows the utility to remain in compliance with the normalization rules. This adjustment is accomplished by offsetting the amount of the NOL carryforward against the ADIT balance. The resulting number represents the amount of benefit the utility has actually realized.

Q. Do the Treasury normalization rules govern the treatment of deferred tax assets such as NOL carryforwards?

A. Yes. The IRS has long held that the tax value of an NOL carryforward is a deferred tax asset that must be offset against the ADIT balance to avoid a normalization violation. The IRS reaffirmed its position in some PLRs. In PLR 201438003, for example, the IRS stated that the "reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOL carryforward-related account balance would be inconsistent with the requirements of" IRC § 168(i)(9) and Treasury Regulation § 1.167(*l*). A copy of that PLR is attached to my testimony as Attachment NK-RR-2. Other PLRs to that same effect are attached to my testimony as Attachments NK-RR-3 and NK-RR-4.

Q. Did SPS recognize its NOLs and apply the corresponding normalization method of accounting in its Updated Test Year ADIT balance calculation?

A. Yes. Ms. Niemi explains that use of the NOL carryforward is reflected in SPS's Texas retail jurisdiction cost of service for the Test Year and Updated Test Year. Ms. Niemi also explains that SPS's proposed revenue requirement includes both the current income tax expense and the deferred income tax expense to reflect the depreciation allowance under straight-line book depreciation. SPS's ADIT balance, net of its NOL carryforward, is applied as a reduction to rate base for SPS's Test Year.

Q. What are your recommendations with respect to how the Commission should calculate SPS's Test Year ADIT balance?

A. I recommend that the Commission offset the tax value of SPS's NOL carryforward against SPS's ADIT Test Year balance, per IRS guidance.

VI. <u>THE TAX CUTS AND JOBS ACT</u>

Q. What is the Tax Cuts and Jobs Act?

A. The TCJA was a tax reform law that was enacted in December 2017 that lowered the federal income tax rate and made several other changes.

Q. Have the impacts of the TCJA been reflected in this proceeding?

A. Yes. This proceeding reflects the lower, 21% federal income tax rate as well as the recovery of deficient and return of excess ADIT, and the other adjustments reflected in the Commission's final order adopting the stipulation in Docket No. 47527.

Q. What is deficient or excess ADIT?

A. SPS previously accrued its federal ADIT by applying the then-applicable federal tax rate of 35% to its accrued deferred income taxes. As a result of the corporate federal income tax rate reduction from 35% to 21%, SPS had to revalue its ADIT to reflect that it will only be paying taxes to the IRS at the 21% rate going forward. The difference between the ADIT at 35 % and the ADIT at 21% is recovered or returned to customers. If the tax rate difference drove a regulatory asset, the resulting difference is referred to as "deficient ADIT." If the tax rate difference drove a regulatory liability, the resulting difference is referred to as "excess ADIT." However, in the context of my testimony, I use the term "excess ADIT" to refer to both the excess amounts to be refunded to customers as well as the deficient amounts to be recovered from customers because, for SPS, the net is a regulatory liability that will be refunded over time.

Q. How large are the total company regulatory assets and regulatory liabilities that are included in this case?

A. As of September 30, 2020, SPS had a $1.5 million regulatory asset related to non-plant excess ADIT; a $40.2 million regulatory asset related to NOL excess ADIT; and a $11.3 million regulatory liability related to its non-plant excess ADIT.

Q. What is the ratemaking effect of this regulatory asset and regulatory liability?

A. Currently, the non-plant regulatory asset is included as an increase to rate base, and the non-plant regulatory liability is included as a decrease to rate base. Consistent with the associated non-plant deferred tax assets and deferred tax liabilities, the regulatory asset and liability will remain as increases and decreases to rate base, respectively, until amortized from or to customers.

Q. How is SPS amortizing these non-plant balances?

A. SPS is continuing to amortize all non-plant excess ADIT over 5 years and the NOL-related excess ADIT over 44 years.

Q. What amount of excess non-plant and NOL ADIT amortization is reflected in SPS's cost of service?

A. SPS has included $4.0 million of total company income tax benefit, which represents one year of amortization of excess ADIT related to non-plant and NOL ADIT.

Q. Have there been any changes to the provisions of the TCJA since Docket No. 49831?

A. Yes. The Treasury and IRS issued proposed regulations in September 2019 enabling utilities to take bonus depreciation.

Q. What is bonus depreciation?

A. Bonus depreciation is a type of accelerated depreciation that allows for the immediate expensing of a percentage of the cost of the eligible assets.

Q. What bonus depreciation guidance was provided under the TCJA?

A. Based on the guidance available at the time Docket No. 49831 was filed, utilities were no longer eligible to use bonus depreciation for assets placed in service after December 31, 2017. Although the law provided for bonus depreciation for "qualified property" placed in service before January 1, 2023, "qualified property" was defined to exclude public utility property. Therefore, regulated public utility property appeared to no longer be eligible for bonus depreciation after December 31, 2017.

Q. What did the September 2019 proposed regulations provide?

A. Among other things, these proposed regulations addressed the extent to which public utilities may qualify for bonus depreciation. They provided that public utility property under construction as of September 27, 2017, and placed in service after 2017, may continue to qualify for bonus depreciation as it existed prior to the enactment of the TCJA. Specifically, 50% for eligible property placed in service during 2017, 40% for property placed in service in 2018, and 30% for property placed in service in 2019. Certain longer production-period property placed in service in 2020 may also be eligible for bonus depreciation.

Q. Have the impacts of the proposed regulations been incorporated into this proceeding?

A. Yes. In order for SPS to recognize the benefit of this bonus depreciation as soon as possible, which in turn benefits customers by reducing SPS's tax liability, SPS filed for a Change in Accounting Method with the IRS in 2019. This enabled SPS to receive the bonus depreciation benefits for property placed in service in 2018 and 2019 as part of its 2019 income tax return. This was largely accounted for in the fourth quarter of 2019 and is reflected as an increase in ADIT, thus a reduction to SPS's rate base.

VII. PROPERTY TAXES

Q. Does SPS incur property taxes?

A. Yes. SPS incurs property taxes in each taxing jurisdiction in which it has tangible assets, including production plant, transmission plant, distribution plant, and general plant. SPS has tangible assets in Texas, New Mexico, Oklahoma, and Kansas.

Q. How did SPS calculate the property tax amounts for the Test Year?

A. SPS started with the property tax amounts accrued in each month for the last three months of 2019. SPS calculated those amounts using the 2019 tax rates and the 2019 property tax valuations, which were based on December 31, 2018 plant assets. SPS then added the amounts accrued for each of the first nine months of 2020, which were calculated using the 2019 tax rates and plant assets as of December 31, 2019. This results in a Test Year amount of $61,389,020 in property taxes for the Total Company, as shown on Attachment NK-RR-5, page 2. That amount includes the adjustment to account for property tax that must be capitalized.

Q. How did SPS calculate the property tax to capitalize for 2020?

A. SPS calculated how much of the CWIP balance at the end of 2020 was subject to property tax. SPS then calculated property tax on those CWIP assets using 2019 tax rates. The $896,000 of property tax that was paid on that CWIP amount and was capitalized is shown on Attachment NK-RR-5, page 1, line 6.

Q. Is SPS proposing any other adjustments to the amount of property taxes for purposes of this rate case?

A. Yes. To determine the Test Year amount of property taxes, SPS proposes two adjustments to the Test Year amount. First, SPS proposes to use 2019 tax rates to calculate Test Year property taxes on the 2020 year-end plant balances. Second, SPS proposes to include an adjustment to remove the one-time property taxes related to the Hale Wind Project, which was placed in service in June 2019. This results in a proposed Test Year amount of $72,076,000 in property taxes for the Total Company, as shown on Attachment NK-RR-5, page 1, line 9. That amount includes the adjustment to account for property tax that must be capitalized.

Q. Does this conclude your pre-filed direct testimony?

A. Yes.

AFFIDAVIT

STATE OF MINNESOTA)
)
COUNTY OF HENNEPIN)

NAOMI KOCH, first being sworn on her oath, states:

I am the witness identified in the preceding testimony. I have read the testimony and the accompanying attachment(s) and am familiar with the contents. Based upon my personal knowledge, the facts stated in the testimony are true. In addition, in my judgment and based upon my professional experience, the opinions and conclusions stated in the testimony are true, valid, and accurate.

Naomi Koch

NAOMI KOCH

Subscribed and sworn to before me this 29th day of January, 2021 by NAOMI KOCH.

Taylor Michelle Eakins

Notary Public, State of Minnesota

My Commission Expires: 1/31/2023

TAYLOR MICHELLE EAKINS
NOTARY PUBLIC - MINNESOTA
My Commission Expires Jan. 31, 2023

United States Code Annotated
Title 26. Internal Revenue Code (Refs & Annos)
Subtitle A. Income Taxes (Refs & Annos)
Chapter 1. Normal Taxes and Surtaxes (Refs & Annos)
Subchapter B. Computation of Taxable Income
Part VI. Itemized Deductions for Individuals and Corporations (Refs & Annos)

26 U.S.C.A. § 168, I.R.C. § 168

§ 168. Accelerated cost recovery system

Effective: March 23, 2018
Currentness

(a) General rule.--Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using--

(1) the applicable depreciation method,

(2) the applicable recovery period, and

(3) the applicable convention.

(b) Applicable depreciation method.--For purposes of this section--

(1) In general.--Except as provided in paragraphs (2) and (3), the applicable depreciation method is--

(A) the 200 percent declining balance method,

(B) switching to the straight line method for the 1st taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance.

(2) 150 percent declining balance method in certain cases.--Paragraph (1) shall be applied by substituting "150 percent" for "200 percent" in the case of--

(A) any 15-year or 20-year property not referred to in paragraph (3),

(B) any property (other than property described in paragraph (3)) which is a qualified smart electric meter or qualified smart electric grid system, or

(C) any property (other than property described in paragraph (3)) with respect to which the taxpayer elects under paragraph (5) to have the provisions of this paragraph apply.

[**(D)** Redesignated (C)]

(3) Property to which straight line method applies.--The applicable depreciation method shall be the straight line method in the case of the following property:

(A) Nonresidential real property.

(B) Residential rental property.

(C) Any railroad grading or tunnel bore.

(D) Property with respect to which the taxpayer elects under paragraph (5) to have the provisions of this paragraph apply.

(E) Property described in subsection (e)(3)(D)(ii).

(F) Water utility property described in subsection (e)(5).

(G) Qualified improvement property described in subsection (e)(6).

[**(H), (I)** Repealed. Pub.L. 115-97, Title I, § 13204(a)(2)(A), Dec. 22, 2017, 131 Stat. 2110]

(4) Salvage value treated as zero.--Salvage value shall be treated as zero.

(5) Election.--An election under paragraph (2)(D) or (3)(D) may be made with respect to 1 or more classes of property for any taxable year and once made with respect to any class shall apply to all property in such class placed in service during such taxable year. Such an election, once made, shall be irrevocable.

(c) Applicable recovery period.--For purposes of this section, the applicable recovery period shall be determined in accordance with the following table:

In the case of:	The applicable

	recovery period is:
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Water utility property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years
Any railroad grading or tunnel bore	50 years .

(d) Applicable convention.--For purposes of this section--

(1) In general.--Except as otherwise provided in this subsection, the applicable convention is the half-year convention.

(2) Real property.--In the case of--

(A) nonresidential real property,

(B) residential rental property, and

(C) any railroad grading or tunnel bore,

the applicable convention is the mid-month convention.

(3) Special rule where substantial property placed in service during last 3 months of taxable year.--

(A) In general.--Except as provided in regulations, if during any taxable year--

(i) the aggregate bases of property to which this section applies placed in service during the last 3 months of the taxable year, exceed

(ii) 40 percent of the aggregate bases of property to which this section applies placed in service during such taxable year, the applicable convention for all property to which this section applies placed in service during such taxable year shall be the mid-quarter convention.

(B) Certain property not taken into account.--For purposes of subparagraph (A), there shall not be taken into account--

(i) any nonresidential real property, residential rental property, and railroad grading or tunnel bore, and

(ii) any other property placed in service and disposed of during the same taxable year.

(4) Definitions.--

(A) Half-year convention.--The half-year convention is a convention which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.

(B) Mid-month convention.--The mid-month convention is a convention which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.

(C) Mid-quarter convention.--The mid-quarter convention is a convention which treats all property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) as placed in service (or disposed of) on the mid-point of such quarter.

(e) Classification of property.--For purposes of this section--

(1) In general.--Except as otherwise provided in this subsection, property shall be classified under the following table:

Property shall be treated as:	If such property has a class life (in years) of:
3-year property..	4 or less
5-year property..	More than 4 but less than 10
7-year property..	10 or more but less than 16
10-year property..	16 or more but less than 20
15-year property..	20 or more but less than 25
20-year property..	25 or more.

(2) Residential rental or nonresidential real property.--

(A) Residential rental property.--

(i) Residential rental property.--The term "residential rental property" means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.

(ii) Definitions.--For purposes of clause (i)--

(I) the term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis, and

(II) if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

(B) Nonresidential real property.--The term "nonresidential real property" means section 1250 property which is not--

(i) residential rental property, or

(ii) property with a class life of less than 27.5 years.

(3) Classification of certain property.--

(A) 3-year property.--The term "3-year property" includes--

(i) any race horse--

(I) which is placed in service before January 1, 2018, and

(II) which is placed in service after December 31, 2017, and which is more than 2 years old at the time such horse is placed in service by such purchaser,

(ii) any horse other than a race horse which is more than 12 years old at the time it is placed in service, and

(iii) any qualified rent-to-own property.

(B) 5-year property.--The term “5-year property” includes--

(i) any automobile or light general purpose truck,

(ii) any semi-conductor manufacturing equipment,

(iii) any computer-based telephone central office switching equipment,

(iv) any qualified technological equipment,

(v) any section 1245 property used in connection with research and experimentation,

(vi) any property which--

(I) is described in subparagraph (A) of section 48(a)(3) (or would be so described if “solar or wind energy” were substituted for “solar energy” in clause (i) thereof and the last sentence of such section did not apply to such subparagraph),

(II) is described in paragraph (15) of section 48(l) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) and has a power production capacity of not greater than 80 megawatts, or

(III) is described in section 48(l)(3)(A)(ix) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990), and

(vii) any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business (as defined in section 263A(e)(4)), the original use of which commences with the taxpayer after December 31, 2017.

Nothing in any provision of law shall be construed to treat property as not being described in subclause (I) or (II) of clause (vi) by reason of being public utility property.

(C) 7-year property.--The term “7-year property” includes--

(i) any railroad track,

(ii) any motorsports entertainment complex,

(iii) any Alaska natural gas pipeline,

(iv) any natural gas gathering line the original use of which commences with the taxpayer after April 11, 2005, and

(v) any property which--

(I) does not have a class life, and

(II) is not otherwise classified under paragraph (2) or this paragraph.

(D) 10-year property.--The term “10-year property” includes--

(i) any single purpose agricultural or horticultural structure (within the meaning of subsection (i)(13)),

(ii) any tree or vine bearing fruit or nuts,

(iii) any qualified smart electric meter, and

(iv) any qualified smart electric grid system.

(E) 15-year property.--The term “15-year property” includes--

(i) any municipal wastewater treatment plant,

(ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications,

(iii) any section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet),

(iv) initial clearing and grading land improvements with respect to gas utility property,

(v) any section 1245 property (as defined in section 1245(a)(3)) used in the transmission at 69 or more kilovolts of electricity for sale and the original use of which commences with the taxpayer after April 11, 2005, and

(vi) any natural gas distribution line the original use of which commences with the taxpayer after April 11, 2005, and which is placed in service before January 1, 2011.

[**(vii)** Redesignated (v)]

[**(viii)** Redesignated (vi)]

[**(ix)** Repealed. Pub.L. 115-97, Title I, § 13204(a)(1)(A)(i), Dec. 22, 2017, 131 Stat. 2109]

(F) 20-year property.--The term "20-year property" means initial clearing and grading land improvements with respect to any electric utility transmission and distribution plant.

(4) Railroad grading or tunnel bore.--The term "railroad grading or tunnel bore" means all improvements resulting from excavations (including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

(5) Water utility property.--The term "water utility property" means property--

(A) which is an integral part of the gathering, treatment, or commercial distribution of water, and which, without regard to this paragraph, would be 20-year property, and

(B) any municipal sewer.

(6) Qualified improvement property.--

(A) In general.--The term "qualified improvement property" means any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.

(B) Certain improvements not included.--Such term shall not include any improvement for which the expenditure is attributable to--

(i) the enlargement of the building,

(ii) any elevator or escalator, or

(iii) the internal structural framework of the building.

[**(7), (8) Repealed.** Pub.L. 115-97, Title I, § 13204(a)(1)(B), Dec. 22, 2017, 131 Stat. 2109]

(f) Property to which section does not apply.--This section shall not apply to--

(1) Certain methods of depreciation.--Any property if--

(A) the taxpayer elects to exclude such property from the application of this section, and

(B) for the 1st taxable year for which a depreciation deduction would be allowable with respect to such property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method or similar method).

(2) Certain public utility property.--Any public utility property (within the meaning of subsection (i)(10)) if the taxpayer does not use a normalization method of accounting.

(3) Films and video tape.--Any motion picture film or video tape.

(4) Sound recordings.--Any works which result from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (such as discs, tapes, or other phonorecordings) in which such sounds are embodied.

(5) Certain property placed in service in churning transactions.--

(A) In general.--Property--

(i) described in paragraph (4) of section 168(e) (as in effect before the amendments made by the Tax Reform Act of 1986), or

(ii) which would be described in such paragraph if such paragraph were applied by substituting “1987” for “1981” and “1986” for “1980” each place such terms appear.

(B) Subparagraph (A)(ii) not to apply.--Clause (ii) of subparagraph (A) shall not apply to--

(i) any residential rental property or nonresidential real property,

(ii) any property if, for the 1st taxable year in which such property is placed in service--

(I) the amount allowable as a deduction under this section (as in effect before the date of the enactment of this paragraph) with respect to such property is greater than,

(II) the amount allowable as a deduction under this section (as in effect on or after such date and using the half-year convention) for such taxable year, or

(iii) any property to which this section (as amended by the Tax Reform Act of 1986) applied in the hands of the transferor.

(C) Special rule.--In the case of any property to which this section would apply but for this paragraph, the depreciation deduction under section 167 shall be determined under the provisions of this section as in effect before the amendments made by section 201 of the Tax Reform Act of 1986.

(g) Alternative depreciation system for certain property.--

(1) In general.--In the case of--

(A) any tangible property which during the taxable year is used predominantly outside the United States,

(B) any tax-exempt use property,

(C) any tax-exempt bond financed property,

(D) any imported property covered by an Executive order under paragraph (6),

(E) any property to which an election under paragraph (7) applies,

(F) any property described in paragraph (8), and

(G) any property with a recovery period of 10 years or more which is held by an electing farming business (as defined in section 163(j)(7)(C)),

the depreciation deduction provided by section 167(a) shall be determined under the alternative depreciation system.

(2) Alternative depreciation system.--For purposes of paragraph (1), the alternative depreciation system is depreciation determined by using--

(A) the straight line method (without regard to salvage value),

(B) the applicable convention determined under subsection (d), and

(C) a recovery period determined under the following table:

In the case of:	The recovery period shall be:
(i) Property not described in clause (ii) or (iii)	The class life.
(ii) Personal property with no class life	12 years.
(iii) Residential rental property	30 years
(iv) Nonresidential real property	40 years
(v) Any railroad grading or tunnel bore or water utility property	50 years

(3) Special rules for determining class life.--

(A) Tax-exempt use property subject to lease.--In the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of paragraph (2) shall (notwithstanding any other subparagraph of this paragraph) in no event be less than 125 percent of the lease term.

(B) Special rule for certain property assigned to classes.--For purposes of paragraph (2), in the case of property described in any of the following subparagraphs of subsection (e)(3), the class life shall be determined as follows:

If property is described in subparagraph:	The class life is:
(A)(iii)	4
(B)(ii)	5
(B)(iii)	9.5
(B)(vii)	10
(C)(i)	10
(C)(iii)	22
(C)(iv)	14
(D)(i)	15
(D)(ii)	20
(D)(v)	20

(E)(i)	24
(E)(ii)	24
(E)(iii)	20
(E)(iv)	20
(E)(v)	30
(E)(vi)	35
(F)	25

(C) Qualified technological equipment.--In the case of any qualified technological equipment, the recovery period used for purposes of paragraph (2) shall be 5 years.

(D) Automobiles, etc.--In the case of any automobile or light general purpose truck, the recovery period used for purposes of paragraph (2) shall be 5 years.

(E) Certain real property.--In the case of any section 1245 property which is real property with no class life, the recovery period used for purposes of paragraph (2) shall be 40 years.

(4) Exception for certain property used outside United States.--Subparagraph (A) of paragraph (1) shall not apply to--

(A) any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States or is operated under contract with the United States;

(B) rolling stock which is used within and without the United States and which is--

(i) of a rail carrier subject to part A of subtitle IV of title 49, or

(ii) of a United States person (other than a corporation described in clause (i)) but only if the rolling stock is not leased to one or more foreign persons for periods aggregating more than 12 months in any 24-month period;

(C) any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States;

(D) any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States;

(E) any container of a United States person which is used in the transportation of property to and from the United States;

(F) any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; (43 U.S.C. 1331));

(G) any property which is owned by a domestic corporation or by a United States citizen (other than a citizen entitled to the benefits of section 931 or 933) and which is used predominantly in a possession of the United States by such a corporation or such a citizen, or by a corporation created or organized in, or under the law of, a possession of the United States;

(H) any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U.S.C. 702(3)), or any interest therein, of a United States person;

(I) any cable, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 168(i)(10)(C) applies (or of a wholly owned domestic subsidiary of such a corporation), if such cable is part of a submarine cable system which constitutes part of a communication link exclusively between the United States and one or more foreign countries;

(J) any property (other than a vessel or an aircraft) of a United States person which is used in international or territorial waters within the northern portion of the Western Hemisphere for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters;

(K) any property described in section 48(l)(3)(A)(ix) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) which is owned by a United States person and which is used in international or territorial waters to generate energy for use in the United States; and

(L) any satellite (not described in subparagraph (H)) or other spacecraft (or any interest therein) held by a United States person if such satellite or other spacecraft was launched from within the United States.

For purposes of subparagraph (J), the term "northern portion of the Western Hemisphere" means the area lying west of the 30th meridian west of Greenwich, east of the international dateline, and north of the Equator, but not including any foreign country which is a country of South America.

(5) Tax-exempt bond financed property.--For purposes of this subsection--

(A) In general.--Except as otherwise provided in this paragraph, the term "tax-exempt bond financed property" means any property to the extent such property is financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a).

(B) Allocation of bond proceeds.--For purposes of subparagraph (A), the proceeds of any obligation shall be treated as used to finance property acquired in connection with the issuance of such obligation in the order in which such property is placed in service.

(C) Qualified residential rental projects.--The term “tax-exempt bond financed property” shall not include any qualified residential rental project (within the meaning of section 142(a)(7)).

(6) Imported property.--

(A) Countries maintaining trade restrictions or engaging in discriminatory acts.--If the President determines that a foreign country--

(i) maintains nontariff trade restrictions, including variable import fees, which substantially burden United States commerce in a manner inconsistent with provisions of trade agreements, or

(ii) engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce,

the President may by Executive order provide for the application of paragraph (1)(D) to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by such Executive order. Any period specified in the preceding sentence shall not apply to any property ordered before (or the construction, reconstruction, or erection of which began before) the date of the Executive order unless the President determines an earlier date to be in the public interest and specifies such date in the Executive order.

(B) Imported property.--For purposes of this subsection, the term “imported property” means any property if--

(i) such property was completed outside the United States, or

(ii) less than 50 percent of the basis of such property is attributable to value added within the United States.

For purposes of this subparagraph, the term “United States” includes the Commonwealth of Puerto Rico and the possessions of the United States.

(7) Election to use alternative depreciation system.--

(A) In general.--If the taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, the alternative depreciation system under this subsection shall apply to all property in such class placed in service during such taxable year. Notwithstanding the preceding sentence, in the case of nonresidential real property or residential rental property, such election may be made separately with respect to each property.

(B) Election irrevocable.--An election under subparagraph (A), once made, shall be irrevocable.

(8) Electing real property trade or business.--The property described in this paragraph shall consist of any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in 163(j)(7)(B)).

(h) Tax-exempt use property.--

(1) In general.--For purposes of this section--

(A) Property other than nonresidential real property.--Except as otherwise provided in this subsection, the term "tax-exempt use property" means that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.

(B) Nonresidential real property.--

(i) In general.--In the case of nonresidential real property, the term "tax-exempt use property" means that portion of the property leased to a tax-exempt entity in a disqualified lease.

(ii) Disqualified lease.--For purposes of this subparagraph, the term "disqualified lease" means any lease of the property to a tax-exempt entity, but only if--

(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a) and such entity (or a related entity) participated in such financing,

(II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option,

(III) such lease has a lease term in excess of 20 years, or

(IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.

(iii) 35-percent threshold test.--Clause (i) shall apply to any property only if the portion of such property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property.

(iv) Treatment of improvements.--For purposes of this subparagraph, improvements to a property (other than land) shall not be treated as a separate property.

(v) Leasebacks during 1st 3 months of use not taken into account.--Subclause (IV) of clause (ii) shall not apply to any property which is leased within 3 months after the date such property is first used by the tax-exempt entity (or a related entity).

(C) Exception for short-term leases.--

(i) In general.--Property shall not be treated as tax-exempt use property merely by reason of a short-term lease.

(ii) Short-term lease.--For purposes of clause (i), the term "short-term lease" means any lease the term of which is--

(I) less than 3 years, and

(II) less than the greater of 1 year or 30 percent of the property's present class life.

In the case of nonresidential real property and property with no present class life, subclause (II) shall not apply.

(D) Exception where property used in unrelated trade or business.--The term "tax-exempt use property" shall not include any portion of a property if such portion is predominantly used by the tax-exempt entity (directly or through a partnership of which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under section 511. For purposes of subparagraph (B)(iii), any portion of a property so used shall not be treated as leased to a tax-exempt entity in a disqualified lease.

(E) Nonresidential real property defined.--For purposes of this paragraph, the term "nonresidential real property" includes residential rental property.

(2) Tax-exempt entity.--

(A) In general.--For purposes of this subsection, the term "tax-exempt entity" means--

(i) the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,

(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter,

(iii) any foreign person or entity, and

(iv) any Indian tribal government described in section 7701(a)(40).

For purposes of applying this subsection, any Indian tribal government referred to in clause (iv) shall be treated in the same manner as a State.

(B) Exception for certain property subject to United States tax and used by foreign person or entity.--Clause (iii) of subparagraph (A) shall not apply with respect to any property if more than 50 percent of the gross income for the taxable year derived by the foreign person or entity from the use of such property is--

(i) subject to tax under this chapter, or

(ii) included under section 951 in the gross income of a United States shareholder for the taxable year with or within which ends the taxable year of the controlled foreign corporation in which such income was derived.

For purposes of the preceding sentence, any exclusion or exemption shall not apply for purposes of determining the amount of the gross income so derived, but shall apply for purposes of determining the portion of such gross income subject to tax under this chapter.

(C) Foreign person or entity.--For purposes of this paragraph, the term "foreign person or entity" means--

(i) any foreign government, any international organization, or any agency or instrumentality of any of the foregoing, and

(ii) any person who is not a United States person.

Such term does not include any foreign partnership or other foreign pass-thru entity.

(D) Treatment of certain taxable instrumentalities.--For purposes of this subsection, a corporation shall not be treated as an instrumentality of the United States or of any State or political subdivision thereof if--

(i) all of the activities of such corporation are subject to tax under this chapter, and

(ii) a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof.

(E) Certain previously tax-exempt organizations.--

(i) In general.--For purposes of this subsection, an organization shall be treated as an organization described in subparagraph (A)(ii) with respect to any property (other than property held by such organization) if such organization was an organization (other than a cooperative described in section 521) exempt from tax imposed by this chapter at any time during the 5-year period ending on the date such property was first used by such organization. The preceding sentence and subparagraph (D)(ii) shall not apply to the Federal Home Loan Mortgage Corporation.

(ii) Election not to have clause (i) apply.--

(I) In general.--In the case of an organization formerly exempt from tax under section 501(a) as an organization described in section 501(c)(12), clause (i) shall not apply to such organization with respect to any property if such organization elects not to be exempt from tax under section 501(a) during the tax-exempt use period with respect to such property.

(II) Tax-exempt use period.--For purposes of subclause (I), the term "tax-exempt use period" means the period beginning with the taxable year in which the property described in subclause (I) is first used by the organization and ending with the close of the 15th taxable year following the last taxable year of the applicable recovery period of such property.

(III) Election.--Any election under subclause (I), once made, shall be irrevocable.

(iii) Treatment of successor organizations.--Any organization which is engaged in activities substantially similar to those engaged in by a predecessor organization shall succeed to the treatment under this subparagraph of such predecessor organization.

(iv) First used.--For purposes of this subparagraph, property shall be treated as first used by the organization--

(I) when the property is first placed in service under a lease to such organization, or

(II) in the case of property leased to (or held by) a partnership (or other pass-thru entity) in which the organization is a member, the later of when such property is first used by such partnership or pass-thru entity or when such organization is first a member of such partnership or pass-thru entity.

(3) Special rules for certain high technology equipment.--

(A) Exemption where lease term is 5 years or less.--For purposes of this section, the term "tax-exempt use property" shall not include any qualified technological equipment if the lease to the tax-exempt entity has a lease term of 5 years or less. Notwithstanding subsection (i)(3)(A)(i), in determining a lease term for purposes of the preceding sentence, there shall not be taken into account any option of the lessee to renew at the fair market value rent determined at the time of renewal; except that the aggregate period not taken into account by reason of this sentence shall not exceed 24 months.

(B) Exception for certain property.--

(i) In general.--For purposes of subparagraph (A), the term "qualified technological equipment" shall not include any property leased to a tax-exempt entity if--

(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a),

(II) such lease occurs after a sale (or other transfer) of the property by, or lease of such property from, such entity (or related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease, or

(III) such tax-exempt entity is the United States or any agency or instrumentality of the United States.

(ii) Leasebacks during 1st 3 months of use not taken into account.--Subclause (II) of clause (i) shall not apply to any property which is leased within 3 months after the date such property is first used by the tax-exempt entity (or a related entity).

(4) Related entities.--For purposes of this subsection--

(A)(i) Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality which directly or indirectly derives its powers, rights, and duties in whole or in part from the same sovereign authority.

(ii) For purposes of clause (i), the United States, each State, and each possession of the United States shall be treated as a separate sovereign authority.

(B) Any entity not described in subparagraph (A)(i) is related to any other entity if the 2 entities have--

(i) significant common purposes and substantial common membership, or

(ii) directly or indirectly substantial common direction or control.

(C)(i) An entity is related to another entity if either entity owns (directly or through 1 or more entities) a 50 percent or greater interest in the capital or profits of the other entity.

(ii) For purposes of clause (i), entities treated as related under subparagraph (A) or (B) shall be treated as 1 entity.

(D) An entity is related to another entity with respect to a transaction if such transaction is part of an attempt by such entities to avoid the application of this subsection.

(5) Tax-exempt use of property leased to partnerships, etc., determined at partner level.--For purposes of this subsection--

(A) In general.--In the case of any property which is leased to a partnership, the determination of whether any portion of such property is tax-exempt use property shall be made by treating each tax-exempt entity partner's proportionate share (determined under paragraph (6)(C)) of such property as being leased to such partner.

(B) Other pass-thru entities; tiered entities.--Rules similar to the rules of subparagraph (A) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(C) Presumption with respect to foreign entities.--Unless it is otherwise established to the satisfaction of the Secretary, it shall be presumed that the partners of a foreign partnership (and the beneficiaries of any other foreign pass-thru entity) are persons who are not United States persons.

(6) Treatment of property owned by partnerships, etc.--

(A) In general.--For purposes of this subsection, if--

(i) any property which (but for this subparagraph) is not tax-exempt use property is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and

(ii) any allocation to the tax-exempt entity of partnership items is not a qualified allocation,

an amount equal to such tax-exempt entity's proportionate share of such property shall (except as provided in paragraph (1)(D)) be treated as tax-exempt use property.

(B) Qualified allocation.--For purposes of subparagraph (A), the term "qualified allocation" means any allocation to a tax-exempt entity which--

(i) is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and

(ii) has substantial economic effect within the meaning of section 704(b)(2).

For purposes of this subparagraph, items allocated under section 704(c) shall not be taken into account.

(C) Determination of proportionate share.--

(i) In general.--For purposes of subparagraph (A), a tax-exempt entity's proportionate share of any property owned by a partnership shall be determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share.

(ii) Determination where allocations vary.--For purposes of clause (i), if a tax-exempt entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive.

(D) Determination of whether property used in unrelated trade or business.--For purposes of this subsection, in the case of any property which is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, the determination of whether such property is used in an unrelated trade or business of such an entity shall be made without regard to section 514.

(E) Other pass-thru entities; tiered entities.--Rules similar to the rules of subparagraphs (A), (B), (C), and (D) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(F) Treatment of certain taxable entities.--

(i) In general.--For purposes of this paragraph and paragraph (5), except as otherwise provided in this subparagraph, any tax-exempt controlled entity shall be treated as a tax-exempt entity.

(ii) Election.--If a tax-exempt controlled entity makes an election under this clause--

(I) such entity shall not be treated as a tax-exempt entity for purposes of this paragraph and paragraph (5), and

(II) any gain recognized by a tax-exempt entity on any disposition of an interest in such entity (and any dividend or interest received or accrued by a tax-exempt entity from such tax-exempt controlled entity) shall be treated as unrelated business taxable income for purposes of section 511.

Any such election shall be irrevocable and shall bind all tax-exempt entities holding interests in such tax-exempt controlled entity. For purposes of subclause (II), there shall only be taken into account dividends which are properly allocable to income of the tax-exempt controlled entity which was not subject to tax under this chapter.

(iii) Tax-exempt controlled entity.--

(I) In general.--The term "tax-exempt controlled entity" means any corporation (which is not a tax-exempt entity determined without regard to this subparagraph and paragraph (2)(E)) if 50 percent or more (in value) of the stock in such corporation is held by 1 or more tax-exempt entities (other than a foreign person or entity).

(II) Only 5-percent shareholders taken into account in case of publicly traded stock.--For purposes of subclause (I), in the case of a corporation the stock of which is publicly traded on an established securities market, stock held by a tax-exempt entity shall not be taken into account unless such entity holds at least 5 percent (in value) of the stock in such corporation. For purposes of this subclause, related entities (within the meaning of paragraph (4)) shall be treated as 1 entity.

(III) Section 318 to apply.--For purposes of this clause, a tax-exempt entity shall be treated as holding stock which it holds through application of section 318 (determined without regard to the 50-percent limitation contained in subsection (a)(2)(C) thereof).

(G) Regulations.--For purposes of determining whether there is a qualified allocation under subparagraph (B), the regulations prescribed under paragraph (8) for purposes of this paragraph--

(i) shall set forth the proper treatment for partnership guaranteed payments, and

(ii) may provide for the exclusion or segregation of items.

(7) Lease.--For purposes of this subsection, the term "lease" includes any grant of a right to use property.

(8) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(i) Definitions and special rules.--For purposes of this section--

(1) Class life.--Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets. The reference in this paragraph to subsection (m) of section 167 shall be treated as a reference to such subsection as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990.

(2) Qualified technological equipment.--

(A) In general.--The term "qualified technological equipment" means--

(i) any computer or peripheral equipment,

(ii) any high technology telephone station equipment installed on the customer's premises, and

(iii) any high technology medical equipment.

(B) Computer or peripheral equipment defined.--For purposes of this paragraph--

(i) In general.--The term "computer or peripheral equipment" means--

(I) any computer, and

(II) any related peripheral equipment.

(ii) Computer.--The term "computer" means a programmable electronically activated device which--

(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

(iii) Related peripheral equipment.--The term "related peripheral equipment" means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

(iv) Exceptions.--The term "computer or peripheral equipment" shall not include--

(I) any equipment which is an integral part of other property which is not a computer,

(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

(III) equipment of a kind used primarily for amusement or entertainment of the user.

(C) High technology medical equipment.--For purposes of this paragraph, the term "high technology medical equipment" means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

(3) Lease term.--

(A) In general.--In determining a lease term--

(i) there shall be taken into account options to renew,

(ii) the term of a lease shall include the term of any service contract or similar arrangement (whether or not treated as a lease under section 7701(e))--

(I) which is part of the same transaction (or series of related transactions) which includes the lease, and

(II) which is with respect to the property subject to the lease or substantially similar property, and

(iii) 2 or more successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property shall be treated as 1 lease.

(B) Special rule for fair rental options on nonresidential real property or residential rental property.--For purposes of clause (i) of subparagraph (A), in the case of nonresidential real property or residential rental property, there shall not be taken into account any option to renew at fair market value, determined at the time of renewal.

(4) General asset accounts.--Under regulations, a taxpayer may maintain 1 or more general asset accounts for any property to which this section applies. Except as provided in regulations, all proceeds realized on any disposition of property in a general asset account shall be included in income as ordinary income.

(5) Changes in use.--The Secretary shall, by regulations, provide for the method of determining the deduction allowable under section 167(a) with respect to any tangible property for any taxable year (and the succeeding taxable years) during which such property changes status under this section but continues to be held by the same person.

(6) Treatments of additions or improvements to property.--In the case of any addition to (or improvement of) any property--

(A) any deduction under subsection (a) for such addition or improvement shall be computed in the same manner as the deduction for such property would be computed if such property had been placed in service at the same time as such addition or improvement, and

(B) the applicable recovery period for such addition or improvement shall begin on the later of--

(i) the date on which such addition (or improvement) is placed in service, or

(ii) the date on which the property with respect to which such addition (or improvement) was made is placed in service.

(7) Treatment of certain transferees.--

(A) In general.--In the case of any property transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of computing the depreciation deduction determined under this section with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. In any case where this section as in effect before the amendments made by section 201 of the Tax Reform Act of 1986 applied to the property in the hands of the transferor, the reference in the preceding sentence to this section shall be treated as a reference to this section as so in effect.

(B) Transactions covered.--The transactions described in this subparagraph are--

(i) any transaction described in section 332, 351, 361, 721, or 731, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(C) Property reacquired by the taxpayer.--Under regulations, property which is disposed of and then reacquired by the taxpayer shall be treated for purposes of computing the deduction allowable under subsection (a) as if such property had not been disposed of.

(8) Treatment of leasehold improvements.--

(A) In general.--In the case of any building erected (or improvements made) on leased property, if such building or improvement is property to which this section applies, the depreciation deduction shall be determined under the provisions of this section.

(B) Treatment of lessor improvements which are abandoned at termination of lease.--An improvement--

(i) which is made by the lessor of leased property for the lessee of such property, and

(ii) which is irrevocably disposed of or abandoned by the lessor at the termination of the lease by such lessee,

shall be treated for purposes of determining gain or loss under this title as disposed of by the lessor when so disposed of or abandoned.

(C) Cross reference.--

For treatment of qualified long-term real property constructed or improved in connection with cash or rent reduction from lessor to lessee, see section 110(b).

(9) Normalization rules.--

(A) In general.--In order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2)--

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such 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; and

(ii) if the amount allowable as a deduction under this section with respect to such property (respecting all elections made by the taxpayer under this section) differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(B) Use of inconsistent estimates and projections, etc.--

(i) In general.--One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

(ii) Use of inconsistent estimates and projections.--The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

(iii) Regulatory authority.--The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

(C) Public utility property which does not meet normalization rules.--In the case of any public utility property to which this section does not apply by reason of subsection (f)(2), the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (A)(i).

(10) Public utility property.--The term “public utility property” means property used predominantly in the trade or business of the furnishing or sale of--

(A) electrical energy, water, or sewage disposal services,

(B) gas or steam through a local distribution system,

(C) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(D) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(11) Research and experimentation.--The term "research and experimentation" has the same meaning as the term research and experimental has under section 174.

(12) Section 1245 and 1250 property.--The terms "section 1245 property" and "section 1250 property" have the meanings given such terms by sections 1245(a)(3) and 1250(c), respectively.

(13) Single purpose agricultural or horticultural structure.--

(A) In general.--The term "single purpose agricultural or horticultural structure" means--

(i) a single purpose livestock structure, and

(ii) a single purpose horticultural structure.

(B) Definitions.--For purposes of this paragraph--

(i) Single purpose livestock structure.--The term "single purpose livestock structure" means any enclosure or structure specifically designed, constructed, and used--

(I) for housing, raising, and feeding a particular type of livestock and their produce, and

(II) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subclause (I).

(ii) Single purpose horticultural structure.--The term "single purpose horticultural structure" means--

(I) a greenhouse specifically designed, constructed, and used for the commercial production of plants, and

(II) a structure specifically designed, constructed, and used for the commercial production of mushrooms.

(iii) Structures which include work space.--An enclosure or structure which provides work space shall be treated as a single purpose agricultural or horticultural structure only if such work space is solely for--

(I) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce,

(II) the maintenance of the enclosure or structure, and

(III) the maintenance or replacement of the equipment or stock enclosed or housed therein.

(iv) Livestock.--The term "livestock" includes poultry.

(14) Qualified rent-to-own property.--

(A) In general.--The term "qualified rent-to-own property" means property held by a rent-to-own dealer for purposes of being subject to a rent-to-own contract.

(B) Rent-to-own dealer.--The term "rent-to-own dealer" means a person that, in the ordinary course of business, regularly enters into rent-to-own contracts with customers for the use of consumer property, if a substantial portion of those contracts terminate and the property is returned to such person before the receipt of all payments required to transfer ownership of the property from such person to the customer.

(C) Consumer property.--The term "consumer property" means tangible personal property of a type generally used within the home for personal use.

(D) Rent-to-own contract.--The term "rent-to-own contract" means any lease for the use of consumer property between a rent-to-own dealer and a customer who is an individual which--

(i) is titled "Rent-to-Own Agreement" or "Lease Agreement with Ownership Option," or uses other similar language,

(ii) provides for level (or decreasing where no payment is less than 40 percent of the largest payment), regular periodic payments (for a payment period which is a week or month),

(iii) provides that legal title to such property remains with the rent-to-own dealer until the customer makes all the payments described in clause (ii) or early purchase payments required under the contract to acquire legal title to the item of property,

(iv) provides a beginning date and a maximum period of time for which the contract may be in effect that does not exceed 156 weeks or 36 months from such beginning date (including renewals or options to extend),

(v) provides for payments within the 156-week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer property plus interest,

(vi) provides for payments under the contract that, in the aggregate, do not exceed $10,000 per item of consumer property,

(vii) provides that the customer does not have any legal obligation to make all the payments referred to in clause (ii) set forth under the contract, and that at the end of each payment period the customer may either continue to use the consumer property by making the payment for the next payment period or return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract, and

(viii) provides that the customer has no right to sell, sublease, mortgage, pawn, pledge, encumber, or otherwise dispose of the consumer property until all the payments stated in the contract have been made.

(15) Motorsports entertainment complex.--

(A) In general.--The term “motorsports entertainment complex” means a racing track facility which--

(i) is permanently situated on land, and

(ii) during the 36-month period following the first day of the month in which the asset is placed in service, hosts 1 or more racing events for automobiles (of any type), trucks, or motorcycles which are open to the public for the price of admission.

(B) Ancillary and support facilities.--Such term shall include, if owned by the taxpayer who owns the complex and provided for the benefit of patrons of the complex--

(i) ancillary facilities and land improvements in support of the complex's activities (including parking lots, sidewalks, waterways, bridges, fences, and landscaping),

(ii) support facilities (including food and beverage retailing, souvenir vending, and other nonlodging accommodations), and

(iii) appurtenances associated with such facilities and related attractions and amusements (including ticket booths, race track surfaces, suites and hospitality facilities, grandstands and viewing structures, props, walls, facilities that support the delivery of entertainment services, other special purpose structures, facades, shop interiors, and buildings).

(C) Exception.--Such term shall not include any transportation equipment, administrative services assets, warehouses, administrative buildings, hotels, or motels.

(D) Termination.--Such term shall not include any property placed in service after December 31, 2017.

(16) Alaska natural gas pipeline.--The term "Alaska natural gas pipeline" means the natural gas pipeline system located in the State of Alaska which--

(A) has a capacity of more than 500,000,000,000 Btu of natural gas per day, and

(B) is--

(i) placed in service after December 31, 2013, or

(ii) treated as placed in service on January 1, 2014, if the taxpayer who places such system in service before January 1, 2014, elects such treatment.

Such term includes the pipe, trunk lines, related equipment, and appurtenances used to carry natural gas, but does not include any gas processing plant.

(17) Natural gas gathering line.--The term "natural gas gathering line" means--

(A) the pipe, equipment, and appurtenances determined to be a gathering line by the Federal Energy Regulatory Commission, and

(B) the pipe, equipment, and appurtenances used to deliver natural gas from the wellhead or a commonpoint to the point at which such gas first reaches--

(i) a gas processing plant,

(ii) an interconnection with a transmission pipeline for which a certificate as an interstate transmission pipeline has been issued by the Federal Energy Regulatory Commission,

(iii) an interconnection with an intrastate transmission pipeline, or

(iv) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

(18) Qualified smart electric meters.--

(A) In general.--The term "qualified smart electric meter" means any smart electric meter which--

(i) is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) Smart electric meter.--For purposes of subparagraph (A), the term "smart electric meter" means any time-based meter and related communication equipment which is capable of being used by the taxpayer as part of a system that--

(i) measures and records electricity usage data on a time-differentiated basis in at least 24 separate time segments per day,

(ii) provides for the exchange of information between supplier or provider and the customer's electric meter in support of time-based rates or other forms of demand response,

(iii) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically, and

(iv) provides net metering.

(19) Qualified smart electric grid systems.--

(A) In general.--The term "qualified smart electric grid system" means any smart grid property which--

(i) is used as part of a system for electric distribution grid communications, monitoring, and management placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) Smart grid property.--For the purposes of subparagraph (A), the term "smart grid property" means electronics and related equipment that is capable of--

(i) sensing, collecting, and monitoring data of or from all portions of a utility's electric distribution grid,

(ii) providing real-time, two-way communications to monitor or manage such grid, and

(iii) providing real time analysis of and event prediction based upon collected data that can be used to improve electric distribution system reliability, quality, and performance.

(j) Property on Indian reservations.--

(1) In general.--For purposes of subsection (a), the applicable recovery period for qualified Indian reservation property shall be determined in accordance with the table contained in paragraph (2) in lieu of the table contained in subsection (c).

(2) Applicable recovery period for Indian reservation property.--For purposes of paragraph (1)--

In the case of:	**The applicable recovery period is:**
3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years.

(3) Deduction allowed in computing minimum tax.--For purposes of determining alternative minimum taxable income under section 55, the deduction under subsection (a) for qualified Indian reservation property shall be determined under this section without regard to any adjustment under section 56.

(4) Qualified Indian reservation property defined.--For purposes of this subsection--

(A) In general.--The term "qualified Indian reservation property" means property which is property described in the table in paragraph (2) and which is--

(i) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation,

(ii) not used or located outside the Indian reservation on a regular basis,

(iii) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and

(iv) not property (or any portion thereof) placed in service for purposes of conducting or housing class I, II, or III gaming (as defined in section 4 of the Indian Regulatory Act (25 U.S.C. 2703)).

(B) Exception for alternative depreciation property.--The term "qualified Indian reservation property" does not include any property to which the alternative depreciation system under subsection (g) applies, determined--

(i) without regard to subsection (g)(7) (relating to election to use alternative depreciation system), and

(ii) after the application of section 280F(b) (relating to listed property with limited business use).

(C) Special rule for reservation infrastructure investment.--

(i) In general.--Subparagraph (A)(ii) shall not apply to qualified infrastructure property located outside of the Indian reservation if the purpose of such property is to connect with qualified infrastructure property located within the Indian reservation.

(ii) Qualified infrastructure property.--For purposes of this subparagraph, the term "qualified infrastructure property" means qualified Indian reservation property (determined without regard to subparagraph (A)(ii)) which--

(I) benefits the tribal infrastructure,

(II) is available to the general public, and

(III) is placed in service in connection with the taxpayer's active conduct of a trade or business within an Indian reservation.

Such term includes, but is not limited to, roads, power lines, water systems, railroad spurs, and communications facilities.

(5) Real estate rentals.--For purposes of this subsection, the rental to others of real property located within an Indian reservation shall be treated as the active conduct of a trade or business within an Indian reservation.

(6) Indian reservation defined.--For purposes of this subsection, the term "Indian reservation" means a reservation, as defined in--

(A) section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d)), or

(B) section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).

For purposes of the preceding sentence, such section 3(d) shall be applied by treating the term "former Indian reservations in Oklahoma" as including only lands which are within the jurisdictional area of an Oklahoma Indian tribe (as determined by the Secretary of the Interior) and are recognized by such Secretary as eligible for trust land status under 25 CFR Part 151 (as in effect on the date of the enactment of this sentence).

(7) Coordination with nonrevenue laws.--Any reference in this subsection to a provision not contained in this title shall be treated for purposes of this subsection as a reference to such provision as in effect on the date of the enactment of this paragraph.

(8) Election out.--If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraph (1) shall not apply to all property in such class placed in service during such taxable year. Such election, once made, shall be irrevocable.

(9) Termination.--This subsection shall not apply to property placed in service after December 31, 2017.

(k) Special allowance for certain property.--

(1) Additional allowance.--In the case of any qualified property--

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(2) Qualified property.--For purposes of this subsection--

(A) In general.--The term "qualified property" means property--

(i)(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E), and

(iii) which is placed in service by the taxpayer before January 1, 2027.

(B) Certain property having longer production periods treated as qualified property.--

(i) In general.--The term "qualified property" includes any property if such property--

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) is placed in service by the taxpayer before January 1, 2028,

(III) is acquired by the taxpayer (or acquired pursuant to a written binding contract entered into) before January 1, 2027,

(IV) has a recovery period of at least 10 years or is transportation property,

(V) is subject to section 263A, and

(VI) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

(ii) Only pre-January 1, 2027 basis eligible for additional allowance.--In the case of property which is qualified property solely by reason of clause (i), paragraph (1) shall apply only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2027.

(iii) Transportation property.--For purposes of this subparagraph, the term "transportation property" means tangible personal property used in the trade or business of transporting persons or property.

(iv) Application of subparagraph.--This subparagraph shall not apply to any property which is described in subparagraph (C).

(C) Certain aircraft.--The term "qualified property" includes property--

(i) which meets the requirements of subparagraph (A)(ii) and subclauses (II) and (III) of subparagraph (B)(i),

(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,

(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of--

(I) 10 percent of the cost, or

(II) $100,000, and

(iv) which has--

(I) an estimated production period exceeding 4 months, and

(II) a cost exceeding $200,000.

(D) Exception for alternative depreciation property.--The term "qualified property" shall not include any property to which the alternative depreciation system under subsection (g) applies, determined--

(i) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and

(ii) after application of section 280F(b) (relating to listed property with limited business use).

(E) Special rules.--

(i) Self-constructed property.--In the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements of subclause (III) of subparagraph (B)(i) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property before January 1, 2027.

(ii) Acquisition requirements.--An acquisition of property meets the requirements of this clause if--

(I) such property was not used by the taxpayer at any time prior to such acquisition, and

(II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

(iii) Syndication.--For purposes of subparagraph (A)(ii), if--

(I) property is used by a lessor of such property and such use is the lessor's first use of such property,

(II) such property is sold by such lessor or any subsequent purchaser within 3 months after the date such property was originally placed in service (or, in the case of multiple units of property subject to the same lease, within 3 months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and

(III) the user of such property after the last sale during such 3-month period remains the same as when such property was originally placed in service,

such property shall be treated as originally placed in service not earlier than the date of such last sale.

(F) Coordination with section 280F.--For purposes of section 280F--

(i) Automobiles.--In the case of a passenger automobile (as defined in section 280F(d)(5)) which is qualified property, the Secretary shall increase the limitation under section 280F(a)(1)(A)(i) by $8,000.

(ii) Listed property.--The deduction allowable under paragraph (1) shall be taken into account in computing any recapture amount under section 280F(b)(2).

(iii) Phase down.--In the case of a passenger automobile acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after September 27, 2017, clause (i) shall be applied by substituting for "$8,000"--

(I) in the case of an automobile placed in service during 2018, $6,400, and

(II) in the case of an automobile placed in service during 2019, $4,800.

(G) Deduction allowed in computing minimum tax.--For purposes of determining alternative minimum taxable income under section 55, the deduction under section 167 for qualified property shall be determined without regard to any adjustment under section 56.

(H) Production placed in service.--For purposes of subparagraph (A)--

(i) a qualified film or television production shall be considered to be placed in service at the time of initial release or broadcast, and

(ii) a qualified live theatrical production shall be considered to be placed in service at the time of the initial live staged performance.

[(3) Repealed. Pub.L. 115-97, Title I, § 13204(a)(4)(B)(ii), Dec. 22, 2017, 131 Stat. 2111]

[(4) Repealed. Pub.L. 115-97, Title I, § 12001(b)(13), Dec. 22, 2017, 131 Stat. 2094]

(5) Special rules for certain plants bearing fruits and nuts.--

(A) In general.--In the case of any specified plant which is planted before January 1, 2027, or is grafted before such date to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business (as defined in section 263A(e)(4)) during a taxable year for which the taxpayer has elected the application of this paragraph--

(i) a depreciation deduction equal to the applicable percentage of the adjusted basis of such specified plant shall be allowed under section 167(a) for the taxable year in which such specified plant is so planted or grafted, and

(ii) the adjusted basis of such specified plant shall be reduced by the amount of such deduction.

(B) Specified plant.--For purposes of this paragraph, the term "specified plant" means--

(i) any tree or vine which bears fruits or nuts, and

(ii) any other plant which will have more than one crop or yield of fruits or nuts and which generally has a pre-productive period of more than 2 years from the time of planting or grafting to the time at which such plant begins bearing a marketable crop or yield of fruits or nuts.

Such term shall not include any property which is planted or grafted outside of the United States.

(C) Election revocable only with consent.--An election under this paragraph may be revoked only with the consent of the Secretary.

(D) Additional depreciation may be claimed only once.--If this paragraph applies to any specified plant, such specified plant shall not be treated as qualified property in the taxable year in which placed in service.

(E) Deduction allowed in computing minimum tax.--Rules similar to the rules of paragraph (2)(G) shall apply for purposes of this paragraph.

[(F) Repealed. Pub.L. 115-97, Title I, § 13201(a)(3)(A), Dec. 22, 2017, 131 Stat. 2106]

(6) Applicable percentage.--For purposes of this subsection--

(A) In general.--Except as otherwise provided in this paragraph, the term "applicable percentage" means--

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 20 percent.

(B) Rule for property with longer production periods.--In the case of property described in subparagraph (B) or (C) of paragraph (2), the term "applicable percentage" means--

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent,

(ii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,

(iii) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,

(iv) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and

(v) in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

(C) Rule for plants bearing fruits and nuts.--In the case of a specified plant described in paragraph (5), the term "applicable percentage" means--

(i) in the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of a plant which is planted or grafted after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of a plant which is planted or grafted after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of a plant which is planted or grafted after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of a plant which is planted or grafted after December 31, 2025, and before January 1, 2027, 20 percent.

(7) Election out.--If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraphs (1) and (2)(F) shall not apply to any qualified property in such class placed in service during such taxable year. An election under this paragraph may be revoked only with the consent of the Secretary.

(8) Phase down.--In the case of qualified property acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after September 27, 2017, paragraph (6) shall be applied by substituting for each percentage therein--

(A) "50 percent" in the case of--

(i) property placed in service before January 1, 2018, and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2018,

(B) "40 percent" in the case of--

(i) property placed in service in 2018 (other than property described in subparagraph (B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2019,

(C) "30 percent" in the case of--

(i) property placed in service in 2019 (other than property described in subparagraph (B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2020, and

(D) "0 percent" in the case of--

(i) property placed in service after 2019 (other than property described in subparagraph (B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service after 2020.

(9) Exception for certain property.--The term "qualified property" shall not include--

(A) any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A), or

(B) any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section.

(10) Special rule for property placed in service during certain periods.--

(A) In general.--In the case of qualified property placed in service by the taxpayer during the first taxable year ending after September 27, 2017, if the taxpayer elects to have this paragraph apply for such taxable year, paragraphs (1)(A) and (5)(A)(i) shall be applied by substituting "50 percent" for "the applicable percentage".

(B) Form of election.--Any election under this paragraph shall be made at such time and in such form and manner as the Secretary may prescribe.

(l) Special allowance for second generation biofuel plant property.--

(1) Additional allowance.--In the case of any qualified second generation biofuel plant property--

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to 50 percent of the adjusted basis of such property, and

(B) the adjusted basis of such property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(2) Qualified second generation biofuel plant property.--The term "qualified second generation biofuel plant property" means property of a character subject to the allowance for depreciation--

(A) which is used in the United States solely to produce second generation biofuel (as defined in section 40(b)(6)(E)),

(B) the original use of which commences with the taxpayer after the date of the enactment of this subsection,

(C) which is acquired by the taxpayer by purchase (as defined in section 179(d)) after the date of the enactment of this subsection, but only if no written binding contract for the acquisition was in effect on or before the date of the enactment of this subsection, and

(D) which is placed in service by the taxpayer before January 1, 2018.

(3) Exceptions.--

(A) Bonus depreciation property under subsection (k).--Such term shall not include any property to which subsection (k) applies.

(B) Alternative depreciation property.--Such term shall not include any property described in subsection (k)(2)(D).

(C) Tax-exempt bond-financed property.--Such term shall not include any property any portion of which is financed with the proceeds of any obligation the interest on which is exempt from tax under section 103.

(D) Election out.--If a taxpayer makes an election under this subparagraph with respect to any class of property for any taxable year, this subsection shall not apply to all property in such class placed in service during such taxable year.

(4) Special rules.--For purposes of this subsection, rules similar to the rules of subsection (k)(2)(E) shall apply.

(5) Allowance against alternative minimum tax.--For purposes of this subsection, rules similar to the rules of subsection (k)(2)(G) shall apply.

(6) Recapture.--For purposes of this subsection, rules similar to the rules under section 179(d)(10) shall apply with respect to any qualified second generation biofuel plant property which ceases to be qualified second generation biofuel plant property.

(7) Denial of double benefit.--Paragraph (1) shall not apply to any qualified second generation biofuel plant property with respect to which an election has been made under section 179C (relating to election to expense certain refineries).

(8) Redesignated (7)

(m) Special allowance for certain reuse and recycling property.--

(1) In general.--In the case of any qualified reuse and recycling property--

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to 50 percent of the adjusted basis of the qualified reuse and recycling property, and

(B) the adjusted basis of the qualified reuse and recycling property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(2) Qualified reuse and recycling property.--For purposes of this subsection--

(A) In general.--The term “qualified reuse and recycling property” means any reuse and recycling property--

(i) to which this section applies,

(ii) which has a useful life of at least 5 years,

(iii) the original use of which commences with the taxpayer after August 31, 2008, and

(iv) which is--

(I) acquired by purchase (as defined in section 179(d)(2)) by the taxpayer after August 31, 2008, but only if no written binding contract for the acquisition was in effect before September 1, 2008, or

(II) acquired by the taxpayer pursuant to a written binding contract which was entered into after August 31, 2008.

(B) Exceptions.--

(i) Bonus depreciation property under subsection (k)--The term “qualified reuse and recycling property” shall not include any property to which subsection (k) (determined without regard to paragraph (4) thereof) applies.

(ii) Alternative depreciation property.--The term “qualified reuse and recycling property” shall not include any property to which the alternative depreciation system under subsection (g) applies, determined without regard to paragraph (7) of subsection (g) (relating to election to have system apply).

(iii) Election out.--If a taxpayer makes an election under this clause with respect to any class of property for any taxable year, this subsection shall not apply to all property in such class placed in service during such taxable year.

(C) Special rule for self-constructed property.--In the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements of clause (iv) of subparagraph (A) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property after August 31, 2008.

(D) Deduction allowed in computing minimum tax.--For purposes of determining alternative minimum taxable income under section 55, the deduction under subsection (a) for qualified reuse and recycling property shall be determined under this section without regard to any adjustment under section 56.

(3) Definitions.--For purposes of this subsection--

(A) Reuse and recycling property.--

(i) In general.--The term “reuse and recycling property” means any machinery and equipment (not including buildings or real estate), along with all appurtenances thereto, including software necessary to operate such equipment, which is used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials.

(ii) Exclusion.--Such term does not include rolling stock or other equipment used to transport reuse and recyclable materials.

(B) Qualified reuse and recyclable materials.--

(i) In general.--The term “qualified reuse and recyclable materials” means scrap plastic, scrap glass, scrap textiles, scrap rubber, scrap packaging, recovered fiber, scrap ferrous and nonferrous metals, or electronic scrap generated by an individual or business.

(ii) Electronic scrap.--For purposes of clause (i), the term “electronic scrap” means--

(I) any cathode ray tube, flat panel screen, or similar video display device with a screen size greater than 4 inches measured diagonally, or

(II) any central processing unit.

(C) Recycling or recycle.--The term "recycling" or "recycle" means that process (including sorting) by which worn or superfluous materials are manufactured or processed into specification grade commodities that are suitable for use as a replacement or substitute for virgin materials in manufacturing tangible consumer and commercial products, including packaging.

[**(n) Repealed.** Pub.L. 115-141, Div. U, Title IV, § 401(b)(13)(A), Mar. 23, 2018, 132 Stat. 1202]

CREDIT(S)

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121(a), 122(a), 123(a), 124(a), 125(a), (c) to (d)(3), 157(a), Title II, §§ 202(e), 210(c), (d), (g)(2), 211(b), 212(b), 214(b), Dec. 19, 2014, 128 Stat. 4015 to 4017, 4022, 4024, 4031 to 4034; Pub.L. 114-113, Div. Q, Title I, §§ 123(a), (b), 143(a)(1), (3), (4), (b)(1) to (6)(G), (J), 165(a), 166(a), 167(a), (b), 189(a), Dec. 18, 2015, 129 Stat. 3052, 3056, 3057 to 3064, 3067, 3075; Pub.L. 115-97, Title I, §§ 12001(b)(13), 13201(a), (b)(1), (b)(2)(B) to (g), 13203(a), (b), 13204(a), 13205(a), 13504(b)(1), Dec. 22, 2017, 131 Stat. 2094, 2105 to 2109, 2111, 2142; Pub.L. 115-123, Div. D, Title I, §§ 40304(a), 40305(a), 40306(a), 40412(a), Feb. 9, 2018, 132 Stat. 146, 151; Pub.L. 115-141, Div. U, Title I, § 101(d)(1), (2), (e), Title III, § 302(a), Title IV, § 401(a)(49), (50), (b)(13)(A), (d)(1)(D)(iv), Mar. 23, 2018, 132 Stat. 1160, 1161, 1184, 1186, 1202, 1207.)

26 U.S.C.A. § 168, 26 USCA § 168
Current through P.L. 116-21.

End of Document

Code of Federal Regulations
Title 26. Internal Revenue
Chapter I. Internal Revenue Service, Department of the Treasury
Subchapter A. Income Tax
Part 1. Income Taxes (Refs & Annos)
Normal Taxes and Surtaxes
Computation of Taxable Income
Itemized Deductions for Individuals and Corporations

26 C.F.R. § 1.167(l)–1, Treas. Reg. § 1.167(l)–1

§ 1.167(l)–1 Limitations on reasonable allowance in case of property of certain public utilities.

Currentness

(a) In general—(1) Scope. Section 167(*l*) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre–1970 public utility property" and in paragraph (d) of this section for "post–1969 public utility property." Under section 167(*l*), a taxpayer may always use a straight line method (or other "subsection (l) method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(*l*) if the taxpayer used a "flow-through method of regulated accounting" (described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (l) method be used in the case of pre–1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utility property defined in section 167(l)(3)(A) 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 section 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. Regulations under section 167(l) 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. The rules provided in paragraph (h)(6) of this section 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 may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. 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 formula serves to limit the amount of such disallowance.

(2) Methods of depreciation. For purposes of section 167(*l*), in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167(*l*), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of "guideline lives" or "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account is not treated for purposes of section 167(*l*) as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account is not treated as a different method of depreciation.

(3) Application of certain other provisions to public utility property. For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of "class lives" for Federal income tax purposes and different lives on the taxpayer's regulated books of account, see § 1.167(a)–11 and § 1.167(a)–12.

(4) Effect on agreements under section 167(d). If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167(*l*), such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) Effect of change in method of depreciation. If, because the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167(l), the taxpayer changes to a method of depreciation not prohibited by section 167(l), then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) Public utility property—(1) In general. Under section 167(l)(3)(A), property is "public utility property" during any period in which it is used predominantly in a "section 167(l) public utility activity". The term "section 167(l) public utility activity" means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, are regulated, *i.e.,* have been established or approved by a regulatory body described in section 167(*l*)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" 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 similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved.

(2) Classification of property. If property is not used solely in a section 167(*l*) public utility activity, such property shall be public utility property if its predominant use is in a section 167(*l*) public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargeable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of § 1.46–3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in § 1.46–3(g)(4) apply, except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) Pre–1970 public utility property—(1) Definition. (i) Under section 167(*l*)(3)(B), the term "pre–1970 public utility property" means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre–1970 public utility property, such property shall be pre–1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's-length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as corporation Y sells pre–1970 public utility property to Y, such property is pre–1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by reference to the basis of any of the taxpayer's pre–1970 public utility property by reason of the application of any provision of the code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre–1970 public utility property immediately before the transaction, the property acquired is pre–1970 public utility property.

(2) Methods of depreciation not prohibited. Under section 167(l)(1), in the case of pre–1970 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method, or

(ii) The applicable 1968 method (other than a subsection (l) method) used by the taxpayer for such property, but only if—

(a) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(b) The taxpayer used a flow-through method of regulated accounting for such property for its July 1969 regulated accounting period, or

(c) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) Flow-through method of regulated accounting in certain cases. See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-through method of regulated accounting for the July 1969 regulated accounting period.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), used the straight line method of depreciation (a subsection (l) method) for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return). Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection (l) method with respect to all of its public utility property. Thus, with respect to its pre–1970 public utility property, X may only use a straight line method (or any other subsection (l) method) of depreciation for all taxable years after 1967.

Example 2. Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straight line rate for all of its nonsection 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all of such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting periods. If Y continues to use a normalization method of regulated accounting, Y may compute its reasonable allowance for purposes of section 167(a) using such 150 percent declining balance method for its nonsection 1250 pre–1970 public utility property for all taxable years beginning with 1968, provided the use of such method is allowable without regard to section 167(l). Y may also use a subsection (l) method for any of such pre–1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre–1970 public utility property for any taxable year beginning after 1967.

Example 3. Assume the same facts as in example (2) except that with respect to all of its nonsection 1250 pre–1970 public utility property accounted for in its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre–1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167(l).

(d) Post–1969 public utility property—(1) In general. Under section 167(l)(3)(C), the term "post–1969 public utility property" means any public utility property which is not pre–1970 public utility property.

(2) Methods of depreciation not prohibited. Under section 167(l)(2), in the case of post–1969 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection (l) method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section 167(l)(4)(A) applies. See § 1.167(l)(2) for rules with respect to an election under section 167(l)(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post–1969 public utility property under a straight line method (or other subsection (l) method) or, if X uses a normalization method of regulated accounting, any other method of depreciation, provided that the use of such other method is allowable under section 167 without regard to section 167(l).

Example 2. Assume the same facts as in example (1) except that with respect to all of X's post–1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre–1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flow-through method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post–1969 public utility property by using the straight line method of depreciation (or any other subsection (l) method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) Applicable 1968 method—(1) In general. Under section 167(l)(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term "applicable 1968 method" means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income tax return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, a subsection (l) method.

If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivisions (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term "applicable 1968 method" if such new method results to any public utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and § 1.446–1.

(2) Placed in service. For purposes of this section, property is placed in service on the date on which the period for depreciation begins under section 167. See, for example, § 1.167(a)–10(b) and § 1.167(a)–11(c)(2). If under an averaging convention property which is placed in service (as defined in § 1.46–3(d)(ii)) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167(l) the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) Certain section 1250 property. If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term "applicable 1968 method" means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method determined under subparagraph (1) of this paragraph. For example, if the applicable 1968 method on new section 1250 property is the declining balance method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method, the term "most nearly comparable method" refers to any method of depreciation allowable under section 167(j).

(4) Applicable 1968 method in certain cases. (i)(a) Under section 167(l)(3)(E), if the taxpayer evidenced within the time and manner specified in (b) of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection (l) method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility property of the same (or most similar) kind subsequently placed in service.

(b) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(1) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

(2) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescribed in paragraph (g)(1)(i), (ii), or (iii) of this section.

(ii)(a) If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(b) For purposes of this subdivision (ii), the term "related person" means a person who is related to another person if either immediately before or after the transfer—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a) and the regulations thereunder.

(5) Same or similar. The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the addition did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) Regulated method of accounting in certain cases. Under section 167(l)(4)(B), if with respect to any pre–1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)(b)(1) of this paragraph and with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167(l)(1)(B) and paragraph (c) of this section the taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre–1970 public utility property.

(7) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is a calendar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property is shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1...........................	Before 1965	Straight line	Straight line.
Group 2...........................	After 1964 and before 1968.	Double declining balance.	Double declining balance.
Group 3...........................	After 1967 and before 1969.	....	Do.
Group 4...........................	After 1968	....	Do.

Example 2. Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970 Y did not place in service any generators. In 1970, Y placed in service additional hydroelectric generators. The applicable 1968 method with respect to

the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (*i.e.,* hydroelectric generators) most recently placed in service.

Example 3. Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) Subsection (l) method. Under section 167(l)(3)(F), the term "subsection (l) method" means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight line method or a unit of production method or machine-hour method. The term "subsection (l) method" does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) July 1969 regulated accounting period—(1) In general. Under section 167(l)(3)(I), the term "July 1969 regulated accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference to the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for a period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer's stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term "established securities market" has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If subdivisions (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) July 1969 method of regulated accounting in certain acquisitions. If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference to the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of "related person".

(3) Determination date. For purposes of section 167(l), any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1)(i) or (ii) of this paragraph applies or the entries made on the taxpayer's regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determining X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) Normalization method of accounting—(1) In general. (i) Under section 167(l), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(a) If the same method of depreciation (whether or not a subsection (l) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(b) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (a) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(l)(1)(B) or (2)(C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167(l)–2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of a different method of depreciation under subdivision (i) of this subparagraph 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. Such amount shall be taken into account for the taxable year in which such 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 section 167(a) results in a net operating loss carryover (as determined under section 172) 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 section 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.

(2) Adjustments to reserve. (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1)(i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 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 under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(l) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post–1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under § 1.167(a)–11 (relating to depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax expense and depreciation expense for purposes of determining its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the use by X of a method of depreciation for Federal income tax purposes different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.

Example 2. Assume the same facts as in example (1), except that X elects to apply § 1.167(a)–11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in § 1.167(a)–11(c)(2)(iii)). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in § 1.167(a)–11(b)(6) and in section 167(l)). X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167(l)(3)(G) is $27,429 and the amount in order to satisfy the normalization requirements of § 1.167(a)–11(b)(6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167(l) and § 1.167(a)–11(b)(6))..	$114,285
(2) Line (1), recomputed using a straight line method..	57,142

(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$57,143
(4) Amount to add to reserve under this paragraph (48 percent of line (3))	27,429
(5) Amount in line (2)	$57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$11,688
(8) Amount to add to reserve under § 1.167(a)–11(b)(6)(ii) (48 percent of line (7))	5,610

If, for its depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example 3. Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167(l)(4)(a) with respect to its “qualified public utility property” (as defined in § 1.167(l)–2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated accounting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example 4. Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

Example 5. Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

(3) Establishing compliance with normalization requirements in respect of operating books of account. The taxpayer may establish compliance with the requirement in subparagraph (l)(i) of this paragraph in respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if (a) such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and (b) the taxpayer's stocks or securities are traded in an established securities market during such taxable year. For purposes of this subdivision, the term “established securities market” has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes. (i) In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre–1970 public utility property, if a regulatory body having jurisdiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection (l) method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post–1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is (a) an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or (b) a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting is being used by the taxpayer with respect to such property.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is a calendar-year taxpayer and its “applicable 1968 method” is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X's use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example 2. Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X has the benefit of the presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation. As the inconsistent decision by the court was handed down prior to the due date of X's Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example 3. Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction, X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and for 1971 and thereafter X must file its returns using a straight line method of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) Change in method of regulated accounting. The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 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 tax expense in computing cost of service in such ratemaking.

(ii) 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 this subparagraph, 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 the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning 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 such 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. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974 for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post–1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting.

With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12–month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within a 9–month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example 2. Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(1) [1] at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be:

January 1–31	$310,000
February 1–28	300,000
March 1–31	300,000
April 1–30	280,000
May 1–31	270,000
June 1–30	260,000
July 1–31	260,000
August 1–31	250,000
September 1–30	240,000
	$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000 x 243/273 =	$275,934
300,000 x 215/273 =	236,264
300,000 x 184/273 =	202,198

280,000 x 154/273 =	157,949
270,000 x 123/273 =	121,648
260,000 x 93/273 =	88,571
260,000 x 62/273 =	59,048
250,000 x 31/273 =	28,388
240,000 x 1/273 =	879
	$1,170,879

Example 3. Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be:

1st quarter	$910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
Total	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000 x 276/365 =	$688,110
810,000 x 185/365 =	410,548
750,000 x 93/365 =	191,096
630,000 x 1/365 =	1,726
	$1,291,480

(i) Flow-through method of regulated accounting. Under section 167(l)(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

Credits

[T.D. 7315, 39 FR 20195, June 7, 1974]

AUTHORITY: Section 1.7701(l)–4 also issued under 26 U.S.C. 7701(l) and 954(c)(6)(A).

Notes of Decisions (1)

Current through June 13, 2019; 84 FR 27542.

Footnotes

1 So in original; probably should read "167(l)".

Internal Revenue Service

Number: **201438003**
Release Date: 9/19/2014

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-104157-14

Date:
June 12, 2014

LEGEND:

Taxpayer =

Parent =

State A =
Commission A =
Commission B =
Year A =
Year B =
Year C =
Year D =
Date A =
Date B =
Date C =
Date D =
Case =
Director =

Dear :

This letter responds to the request, dated January 24, 2014, and additional submission dated May 19, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying electricity in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A and Commission B with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year C. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year D.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of “cost-free” capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer’s proposed calculation of ADIT.

Commission A, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission A further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer’s position, Taxpayer may file seeking an adjustment. Commission A also held that to the extent tax normalization rules require recording the NOL to rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer’s rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer’s NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a “with and without” basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer’s NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) 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 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 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 provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such 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.

Former section 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). 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 section 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 (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss 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 section 167(a) using a subsection (1) 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 section 167(1) 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 section 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 section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 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)-1(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), 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 section 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.

Section 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. Taxpayer has done so. 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. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 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 ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission A is not in accord with the normalization requirements.

Regarding the second issue, § 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. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
(Passthroughs & Special Industries)

cc:

Internal Revenue Service

Number: **201436038**
Release Date: 9/5/2014
Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-148311-13
Date:
May 22, 2014

LEGEND:

Taxpayer =

Parent =

State A =
State B =
State C =
Commission A =
Commission B =
Commission C =
Year A =
Year B =
Date A =
Date B =
Date C =
Date D =
Date E =
Case =
Director =

Dear . :

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned, through a limited liability company, by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer also provides natural gas and natural gas transmission services in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case was updated in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT.

On Date C, a settlement agreement was filed with Commission B, incorporating the Taxpayer's proposed treatment of the tax consequences of its NOLC. In an order issued on Date D, Commission B issued an order approving the settlement agreement and also ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date E.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional eight months. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) 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 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 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 provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such 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.

Former section 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-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 section 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(1)-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 (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss 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 section 167(a) using a subsection (1) 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(1)-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 section 167(1) 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 section 1.167(1)-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 section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 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(1)-(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), 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 section 1.167(1)-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.

Section 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. Taxpayer has done so. Section 1.167(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. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(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 ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, 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 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. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
(Passthroughs & Special Industries)

cc:

Internal Revenue Service

Number: **201436037**
Release Date: 9/5/2014

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-148310-13

Date:
May 22, 2014

LEGEND:

Taxpayer =

Parent =

State A =
State B =
State C =
Commission A =
Commission B =
Commission C =
Year A =
Year B =
Date A =
Date B =
Date C =
Case =
Director =

Dear :

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case included six months of forecast data, which the Taxpayer updated with actual data in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission B was, if Commission B allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then Taxpayer's income tax expense element of service should be reduced by that same amount.

Commission B, in an order issued on Date C, allowed Taxpayer to reduce ADIT by the amount that Taxpayer calculates did not actually defer tax due to the presence of the NOLC and ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date C.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional quarter. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) 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 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 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 provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such 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.

Former section 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-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 section 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(1)-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 (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss 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 section 167(a) using a subsection (1) 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(1)-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 section 167(1) 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 section 1.167(1)-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 section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 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(1)-(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), 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 section 1.167(1)-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.

Section 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. Taxpayer has done so. Section 1.167(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. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(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 ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, 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 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. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
(Passthroughs & Special Industries)

cc:

Southwestern Public Service Company

Line No.	Description		Total Company Property Tax Amounts	
1	TX Property Tax Accrued (2021)*	$	56,772,000	(1)
2	NM Property Tax Accrued (2021)**		17,640,000	(1)
3	KS Property Tax (2021)		1,260,000	(1)
4	OK Property Tax (2021)		660,000	(1)
5	Total SPS Property Tax - Tax Year 2021		76,332,000	
6	Property Tax Capitalized - CWIP Adjustment		(896,000)	(1)
8	Property Tax One Time Payments - Hale		(3,360,000)	(2)
9	Recommended Total Company Property Tax Expense	$	72,076,000	

(1) Estimated 2021 property tax per books based on 12/31/2020 plant balances and 2019 tax rates.
* $7.2M of 2021 TX property tax related to Hale plant balance as of 12/31/2020
** $5.7M of 2021 NM property tax related to Sagamore plant balance as of 12/31/2020
(2) $3.36M of the 2021 TX property tax related to Hale is for a one time payment

Southwestern Public Service Company

Adjusted Property Tax - Updated Test Year

Line No.	Date		Expense Booked Texas	New Mexico	Kansas	Oklahoma	Total
1	Oct-19		$ 3,059,000	$ 980,000	$ 100,000	$ 50,000	$ 4,189,000
2	Nov-19		3,059,000	980,000	100,000	50,000	4,189,000
3	Dec-19		3,059,000	980,000	131,549	43,118	4,213,667
4	Dec-19	#	(244,500)	(77,500)	-	-	(322,000)
5	Jan-20		4,174,000	1,000,000	105,000	50,000	5,329,000
6	Jan-20	*	2,100,000	-	-	-	2,100,000
7	Feb-20		4,144,000	1,030,000	105,000	50,000	5,329,000
8	Mar-20		4,159,000	955,000	105,000	50,000	5,269,000
9	Mar-20	*	-	(1,740,000)	-	-	(1,740,000)
10	Mar-20	##	(345,750)	(33,000)	-	-	(378,750)
11	Apr-20		4,159,000	995,000	105,000	50,000	5,309,000
12	May-20		5,184,000	995,000	105,000	50,000	6,334,000
13	May-20	*	(65,372)	(83,835)	-	-	(149,208)
14	Jun-20		4,364,000	995,000	45,000	50,000	5,454,000
15	Jun-20	##	(345,750)	(33,000)	-	-	(378,750)
16	Jul-20		5,274,000	995,000	95,000	50,000	6,414,000
17	Jul-20	*	311	-	-	-	311
18	Aug-20		4,494,000	995,000	95,000	50,000	5,634,000
19	Sep-20		4,494,000	995,000	95,000	50,000	5,634,000
20	Sep-20	##	(345,750)	(694,500)	-	-	(1,040,250)
21	**TOTAL**		**$ 50,376,189**	**$ 9,233,165**	**$ 1,186,549**	**$ 593,118**	**$ 61,389,020**

* Tax year 2019 true-up
# 2019 Property Tax on CWIP Capitalized
2020 Property Tax on CWIP Capitalized