

5226, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG-104385-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the proposed regulations, David Selig, at (202) 622-3040; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146), and former section 46(f) of the Code. The proposed regulations respond to changes in the electric power industry resulting from deregulation of electricity generation facilities.

Section 168 of the Code permits the use of accelerated depreciation methods. Section 168(f)(2) provides, however, that accelerated depreciation is permitted with respect to public utility property only if the taxpayer uses a normalization method of accounting for ratemaking purposes.

Under a normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater than actual tax expense. The difference between the ratemaking tax expense and the actual tax expense is added to a reserve (the accumulated deferred federal income tax reserve, or ADFIT). The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the

accelerated method used in computing actual tax expense.

This accounting treatment prevents the immediate flowthrough to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus is available to utilities as cost-free investment capital. When the accelerated method provides lower depreciation deductions in later years, only the ratemaking tax expense is collected from ratepayers and the difference between actual tax expense and ratemaking tax expense is charged to ADFIT, depleting the utility's stock of cost-free capital.

Excess Deferred Income Tax

The Tax Reform Act of 1986 reduced the highest corporate tax rate from 46 percent to 34 percent. The excess deferred federal income tax (EDFIT) reserve is the balance of the deferred tax reserve immediately before the rate reduction over the balance that would have been held in the reserve if the 34 percent rate had been in effect for prior periods. The EDFIT reserves were amounts that utilities had collected from ratepayers to pay future taxes that, as a result of the reduction in corporate tax rates, would not have to be paid.

Section 203(e) of the Tax Reform Act of 1986 specifies the manner in which the EDFIT reserve can be flowed through to ratepayers under a normalization method of accounting. It provides that the EDFIT reserve may be reduced, with a corresponding reduction in the cost of service the utility collects from ratepayers, no more rapidly than the EDFIT reserve would be reduced under the average rate assumption method (ARAM). For taxpayers that did not have adequate data to apply the average rate assumption method, subsequent guidance permitted use of the reverse South Georgia method as an alternative. In general, both the average rate assumption method and the reverse South Georgia method spread the flowthrough of the EDFIT reserve over the remaining lives of the property that gave rise to the excess.

Accumulated Deferred Investment Tax Credits (ADITC)

Former section 46 of the Code similarly limited the ability of ratepayers to benefit from the investment tax credit determined under that section. Under former section 46(f)(2), an electing utility could flow through the investment credit ratably

(that is, could reduce the cost of service collected from ratepayers by a ratable portion of the credit) over the investment's regulatory life. The balance of the credit remaining to be flowed through to ratepayers would be held in a reserve for accumulated deferred investment tax credits (ADITC). If the utility elected ratable flowthrough of the credit, the rate base (the amount on which the utility is permitted to collect a return from ratepayers) could not be reduced by reason of any portion of the credit.

Deregulation of Generation Assets

When the normalization provisions were added to the Internal Revenue Code, electric utilities were vertically integrated to include generation, transmission, and distribution functions. Accelerated depreciation, investment credits, and normalization enhanced the cash flow needed to acquire and construct new generation assets. Driven by changes in technology and economics, however, the electric industry has been undergoing substantial changes. Many utilities have been selling generation assets to new entities that are not subject to rate of return regulation and are becoming transmission and distribution (or distribution-only) companies. In many cases, the deregulation of generation assets is occurring before the EDFIT and ADITC reserves associated with those assets have been flowed through to ratepayers.

The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted. After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.

The proposed regulations provide that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, may continue to flow through EDFIT and ADITC reserves associated with those assets without violating the normalization rules. The rate of