ORIGINAL

Commissioner	Yes	No	Not Participating
Huston	√		
Freeman	√		
Krevda	√		
Ober	√		
Ziegner			

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE INDIANA UTILITY REGULATORY COMMISSION'S INVESTIGATION INTO THE IMPACTS OF THE TAX CUTS AND JOBS ACT OF 2017 AND POSSIBLE RATE IMPLICATIONS UNDER PHASE 1 AND PHASE 2 FOR HAMILTON SOUTHEASTERN UTILITIES, INC.	)))))))	**CAUSE NO. 45032 S16** **APPROVED: JAN 06 2021**

ORDER OF THE COMMISSION

Presiding Officers:
James F. Huston, Chairman
Loraine L. Seyfried, Chief Administrative Law Judge

On February 16, 2018, the Indiana Utility Regulatory Commission ("Commission") issued an Order in Cause No. 45032, dividing into two phases the investigation into the Tax Cuts and Jobs Act of 2017 ("TCJA") and its impact on jurisdictional rate-regulated, investor-owned public utilities. The purpose of Phase 1 was "to ascertain the real time existing customer rate impact directly related to the change in the federal income tax rate on the ongoing revenue requirement" for each utility and to "foster an expedient process to reflect such impact in customer rates going forward." *Commission Investigation into the Impacts of the Tax Cuts and Jobs Act of 2017*, Cause No. 45032 at 2, footnotes omitted (IURC Feb. 16, 2018). The purpose of Phase 2 was to address all remaining issues, including the amount and amortization of normalized and non-normalized excess accumulated deferred income taxes and the regulatory accounting being used for recording the estimated impacts from the TCJA in accordance with our January 3, 2018 Order in Cause No. 45032.

This TCJA subdocket ("Subdocket") was created by docket entry issued on May 14, 2018 in Cause No. 45032. The Subdocket proceeding was subsequently stayed by a May 18, 2018 Docket Entry, pending the resolution of HSE's base rate case in Cause No. 44683. On March 23, 2020, a Docket Entry was issued in this Cause lifting the stay and directing that both the Phase 1 and Phase 2 tax issues be addressed in this Subdocket.

On July 2, 2020, Hamilton Southeastern Utilities, Inc. ("Respondent" or "HSE") prefiled its direct testimony and exhibits. On September 8, 2020, the Indiana Office of Utility Consumer Counselor ("OUCC") prefiled its direct testimony and exhibits. On September 28, 2020, HSE prefiled its rebuttal testimony.

On October 9, 2020, HSE and the OUCC responded to the Presiding Officers' request for additional information contained in an October 8, 2020 Docket Entry. Also on October 9, 2020, the OUCC submitted a stipulated cross-examination exhibit.

An evidentiary hearing was scheduled to be held at 9:30 a.m. on October 13, 2020, in Room 222 of the PNC Center, 101 West Washington Street, Indianapolis, Indiana. On October 7, 2020, a docket entry was issued advising that due to the ongoing COVID-19 pandemic and based upon the

parties' agreement, the hearing would be conducted via video conference. Counsel for HSE and the OUCC participated in the evidentiary hearing, and the parties' evidence was admitted into the record without objection.

Based upon the applicable law and evidence presented, the Commission now finds:

1. Notice and Jurisdiction. Notice of the hearing in this Cause was given and published by the Commission as required by law. Respondent is a public utility as defined by Ind. Code § 8-1-2-1. Under Ind. Code § 8-1-2-42, the Commission has jurisdiction over HSE's rates and charges for wastewater service. The Commission also has jurisdiction to initiate investigations into all matters relating to public utilities under Ind. Code §§ 8-1-2-58, 8-1-2-59, and 8-1-2-68. Accordingly, the Commission has jurisdiction over HSE and the subject matter of this Subdocket.

2. Respondent's Characteristics. HSE is a corporation duly organized under the laws of the State of Indiana with its principal office and place of business at 11901 Lakeside Drive, Fishers, Indiana, 46038. HSE owns, operates, and controls utility plant, property, and equipment for the collection, purification, and disposal of sewage. HSE's service territory includes parts of the City of Fishers, the City of Noblesville, and Boone County, Indiana pursuant to certificates of territorial authority and indeterminate permits granted by the Commission over the past thirty years.

3. Evidence Presented.

A. Respondent's Case-in-Chief. Otto W. Krohn, a Certified Public Accountant and executive partner of O.W. Krohn & Associates, LLP, testified that the TCJA impacts investor-owned wastewater utilities such as HSE in three significant ways. First, the TCJA reduces the corporate income tax rate for C corporations from 35% to 21%. Second, Contributions in Aid of Construction ("CIAC"), such as contributed property and cash System Development Charges ("SDCs"), are now taxable for income tax purposes. Third, the reduction in the corporate tax rate affects Accumulated Deferred Income Taxes ("ADIT"), resulting in excess ADIT. Mr. Krohn testified that effective January 1, 2018, HSE converted from an S corporation to a C corporation and provided evidence of HSE's S corporation revocation. According to Mr. Krohn, HSE believes that its status as a C corporation results in the greatest benefit to its customers.

Mr. Krohn testified that HSE performed two Phase 1 calculations showing the impact of the TCJA on its rates. The first calculation was performed by Mr. Krohn based on HSE's current C corporation status. The second calculation was performed by Mr. Mares based on an S corporation status using the income tax expense methodology approved by the Commission in Cause No. 44683, as discussed further below. Under his initial C corporation analysis, Mr. Krohn concluded that HSE's federal and state income tax expense using a blended tax rate of 26.35% was $122,308, which is $10,110 lower than the income tax expense approved by the Commission in HSE's last rate case in Cause No. 44683. Mr. Krohn then multiplied the $10,110 variance by the gross revenue conversion factor of 0.449702 used by the Commission in Cause No. 44683 to arrive at a total income tax expense variance of $14,656. According to Mr. Krohn, the income tax variance of $14,656 results in a 0.12% decrease to HSE's revenue allowance, *i.e.*, a normalized test year revenue increase of 1.05% instead of the 1.17% approved by the Commission in Cause No. 44683, as shown in his Attachment OWK-3.

Regarding Phase 2, Mr. Krohn testified that HSE has a regulatory liability (over-collection) in the amount of $42,734, which is based on HSE's current C corporation status and the 29-month period applicable for tracking the regulatory accounting difference (*i.e.*, January 1, 2018 through May 2020). He explained that the $42,734 amount was calculated by applying the 0.12% revenue reduction shown in his Attachment OWK-3 to the revenues collected by HSE during the 29-month time period for each customer class, as shown in Attachment OWK-4. Mr. Krohn testified that if HSE had remained an S corporation, there would be no regulatory liability amount because HSE's tax expense would be higher as a result of the TCJA. Mr. Krohn also discussed ADIT and how it applies to HSE. According to Mr. Krohn, HSE does not have any excess ADIT that would be subject to refund as a result of the TCJA due to HSE being an S corporation prior to January 1, 2018.

Aaron Bradley Mares, a Certified Public Accountant and managing shareholder of Horizon CPA Services, Inc., testified about the impacts the TCJA has on S corporations and how the TCJA affects the methodology used to determine HSE's income tax expense in Cause No. 44683. Mr. Mares explained that S corporations are not taxed at the company level but are instead taxed at each individual shareholder's respective tax rates based on the shareholder's proportionate share of the company's taxable income at each individual shareholder's taxable rate. According to Mr. Mares, although the TCJA resulted in a significant reduction to the C corporation tax rate, individual tax rates in many cases for higher income earners increased. In addition, he testified that CIAC, which had been exempt from federal income tax for investor-owned sewer utilities such as HSE under the prior tax law, is now considered to be taxable income as a result of the TCJA. According to Mr. Mares, this means any contributed property or cash SDCs received by HSE that becomes CIAC is now taxable income that flows through to HSE's shareholders.

Mr. Mares explained that in Cause No. 44683 he calculated HSE's income tax expense based upon HSE's status at the time as an S corporation using HSE shareholders' proportionate share of the company's taxable income at each individual shareholder's taxable rate. Using HSE's *pro forma* net operating income, he calculated each shareholder's proportionate share of the *pro forma* net operating income to calculate the combined federal tax rate applicable to all of HSE's shareholders based upon a taxpayer's filing status as a single taxpayer. Although the Commission accepted this methodology, Mr. Mares testified that the Commission modified his calculation by finding that the calculation should be based on each shareholder's actual tax filing status (*e.g.*, single, married filing jointly, etc.), resulting in the Commission approving a combined federal and state income tax rate of 26.82%. The Commission then used the 26.82% tax rate to determine HSE's income tax expense to be included in HSE's rates.

Using the methodology approved by the Commission in Cause No. 44683, Mr. Mares performed an updated S corporation calculation that considers the TCJA's changes. Mr. Mares determined that the combined federal tax rate for all of HSE's shareholders would be 24.44% based upon a *pro forma* net utility operating income before income taxes ("NOI") of $1,663,756. According to Mr. Mares, when adding the 24.44% federal rate to the Indiana individual tax rate of 4.4%, the combined federal and state tax rate would be 28.84%, as shown in his Attachment ABM-1. Mr. Mares explained that the $1,663,756 represents HSE's adjusted *pro forma* taxable income pursuant to Cause No. 44683, as adjusted for the TCJA. He calculated this amount by taking the net operating income amount of $493,727 authorized by the Commission in Cause No. 44683 and applying the Commission-approved tax gross-up factor of 26.82% to it, resulting in a pre-tax net operating income amount of $674,675. Mr. Mares then added HSE's 2014 cash SDCs of $735,250 and 2014 contributed

property amount of $253,831 (*i.e.,* 2014 CIAC) to pre-tax net operating income of $674,675 to arrive at HSE's estimated pass-through taxable income amount of $1,663,756.

Mr. Mares explained that HSE's taxable income for its rate case test year of 2014 must be adjusted to include CIAC in order to determine what HSE's shareholders' proportional share of HSE's income would have been if the TCJA had been in effect during 2014 and the income tax bracket each shareholder would have been in when computing HSE's income tax expense. Mr. Mares testified that the 28.84% tax rate he calculated under his updated S corporation analysis is higher than the 26.35% tax rate that Mr. Krohn calculated based upon HSE's current C corporation status and the 26.82% tax rate approved by the Commission in Cause No. 44683, and as a result, there would be no Phase 1 rate reduction to HSE's rates if using the S corporation tax rate of 28.84%.

B. OUCC's Case-in-Chief. Margaret A. Stull, a Chief Technical Advisor in the OUCC's Water/Wastewater Division, identified the main effects of the TCJA on regulated utilities and testified that three major adjustments are necessary to reflect those effects: (1) reduction of federal income tax expense embedded in utility rates to reflect the new income tax rates going forward; (2) refunding of federal income tax expense over-collected by the utility from January 1, 2018 until the federal income tax rate embedded in rates and charges is reduced; and (3) reduction of federal income tax expense to reflect the return of excess ADIT. She noted that the effects of the TCJA on HSE's rates have not yet been addressed.

Ms. Stull disagreed with HSE's Phase 1 conclusion that income tax expense based on the TCJA tax rates applicable to C corporations is lower than the income tax expense calculated under the Commission's methodology for determining HSE's S corporation income tax expense updated for the TCJA. According to Ms. Stull, there are several errors in HSE's calculation of the amount of income tax expense currently embedded in its rates and charges as well as its calculation of C corporation tax expense. Ms. Stull also testified that there are errors and inconsistencies in HSE's calculation of its S corporation income tax expense, as updated by the TCJA, that incorrectly reflect an increase in the updated S corporation tax rate. According to Ms. Stull, these errors and inconsistencies led HSE to an incorrect conclusion regarding the appropriate update to its tax expense under Phase 1. Ms. Stull also questioned the timing of HSE's conversion to a C corporation and whether it's appropriate to base HSE's income tax expense calculation in this proceeding on a C corporation status. She testified that this proceeding is intended to address effects of the TCJA, and the TCJA did not require HSE to convert to a C corporation.

Regarding the income tax expense currently embedded in HSE's rates and charges, Ms. Stull concluded HSE incorrectly used the Commission's stated tax rate of 26.82% instead of the effective tax rate of 25.83%, and HSE incorrectly applied the stated tax rate of 26.82% to the $493,727 return on investment amount authorized by the Commission in Cause No. 44683. She explained that state income taxes are deductible for federal income tax purposes. Therefore, to calculate the effective income tax rate, state and federal income tax rates are added together and then reduced by the product of the state income tax rate multiplied by the federal income tax rate. Ms. Stull concluded that the amount of income tax expense currently embedded in HSE's rates is $172,117, not the $132,418 shown in HSE's Attachment OWK-3. Ms. Stull also disagreed with HSE's C corporation income tax expense calculation under the TCJA, as shown in HSE's Attachment OWK-3. According to Ms. Stull, Mr. Krohn incorrectly applied current C corporation tax rates to the $493,727 return on investment amount authorized by the Commission in Cause No. 44683. Ms. Stull concluded that HSE's income

tax expense using 2018 C corporation tax rates is $171,133, which is only $984 less than the $172,117 income tax expense she concluded is currently embedded in HSE's rates.

Ms. Stull disagreed with the S corporation analysis performed by HSE. According to Ms. Stull, HSE's S corporation analysis is inaccurate because it does not conform to how income tax expense is determined for ratemaking purposes in Indiana and is inconsistent with how income tax expense was determined in Cause No. 44683. She explained that Indiana is a tax normalization state, and income tax expense included in utility rates is based on the utility's treatment of revenues and expenses for book purposes rather than tax purposes. Ms. Stull further explained deferred taxes are created to account for any book to tax differences, and these deferred taxes are included in the determination of base rates either through inclusion in the utility's capital structure as a zero-cost source of capital or as a reduction to rate base. According to Ms. Stull, HSE's income tax expense in Cause No. 44683 was based on its book taxable income rather than its taxable income for tax purposes.

Ms. Stull testified that HSE's determination of taxable income is not in conformance with how income tax expense is determined for ratemaking purposes in Indiana. She explained that while contributions of cash and plant are now considered taxable income for tax purposes due to the TCJA, these same contributions are still considered CIAC for book purposes. Ms. Stull testified that because taxable income for ratemaking purposes should be based on book taxable income, HSE incorrectly included contributed cash and property in its taxable income amount used to determine its S corporation income tax rates in Mr. Mares' Attachment ABM-1. She concluded this is inconsistent with how other book and tax differences were treated in the determination of income tax expense in Cause No. 44683, which was based on book depreciation expense rather than the accelerated depreciation expense reported for tax purposes. Ms. Stull recommended that the calculation of updated S corporation income tax rates applicable to HSE's shareholders should be based on the same taxable income used in Cause No. 44683 adjusted for updated income tax expense and should exclude any CIAC revenues.[1]

Ms. Stull concluded that HSE's income tax expense should be $108,374, which she explained is based on an S corporation income tax rate updated for the TCJA effects and excludes 20% of S corporation taxable income based on the Qualified Business Income ("QBI") deduction established by the TCJA. Her calculation excluded CIAC from HSE's taxable income, which resulted in HSE's shareholders being in lower income tax brackets for purposes of determining the combined federal and state tax rate to be used in the income tax expense calculation. Ms. Stull testified that it was reasonable to conclude that the QBI deduction would apply to HSE's shareholders' taxable income. Based upon an S corporation combined income tax rate of 23.31%, Ms. Stull recommended a Phase 1 revenue reduction of $64,888 and a rate reduction of 0.54% after inclusion of the 20% QBI deduction.

Regarding the Phase 2 tax issues, Ms. Stull disagreed with HSE's calculation of the regulatory liability amount of $42,734 because HSE's calculation of over-collected income tax expense is based on its post-rate case order decision to change its corporate status from an S to a C corporation, which

[1] Ms. Stull testified that HSE had chosen cost option election (2) pursuant to 170 IAC 8.5-4-32. However, the parties corrected this statement in their responses to the Commission's October 8, 2020 Docket Entry. Ms. Stull explained the statement was made in error, and HSE explained that it has always elected cost option (1) under the Commission's regulations and that it has never requested a change to this election.

is not properly reflected between rate cases, and HSE made errors in calculating its income tax expense. She calculated over-collected income tax expense to be $192,300 through May 31, 2020, which is based on the OUCC's recommendation to use updated S corporation rates to determine the amount of income tax expense to be embedded in HSE's base rates and the same billing data HSE used in its regulatory liability calculation in Attachment OWK-4. Ms. Stull recommended that the over-collected amount be refunded to customers over a 12-month period beginning the first month after HSE implements its updated tariff approved in this proceeding. In addition, the over-collected income tax amount should be updated through the date HSE implements its updated base rates as approved in this Cause.

Ms. Stull disagreed with Mr. Krohn that because HSE was an S corporation, it has not historically had any ADIT balances. She testified that because HSE received authorization from the Commission to recover income tax expense through its rates in Cause No. 43761, ADIT and excess ADIT for the period prior to January 1, 2018 should be included in the determination of HSE's base rates and in the resulting ratemaking treatment of TCJA changes in this proceeding. She pointed out HSE's shareholders benefitted from the accelerated depreciation expense taken for tax purposes through reduced taxable income and reduced tax liability, and that benefit should be considered by returning excess ADIT to HSE's customers. Ms. Stull testified that from HSE's inception through December 31, 2017, the cumulative difference between HSE's book and tax depreciation is $2,466,060, resulting in ADIT of $661,000 and excess ADIT of $86,000. However, Ms. Stull explained that ADIT was only funded by ratepayers when HSE began recovering income tax expense for ratemaking purposes starting with the issuance of an order in Cause No. 43761 on August 18, 2010. Therefore, only ADIT accumulated since September 2010 should be included in the determination of excess ADIT for purposes of this tax proceeding. Ms. Stull determined that HSE's excess ADIT, after revaluing ADIT for the current S corporation income tax rate of 23.31% and based on the period of September 2010 through December 31, 2017 is $20,000. Ms. Stull concluded that the annual amortization of the excess ADIT amount of $20,000 yields an amount of $715, which she found to be immaterial for purposes of this proceeding.

Ms. Stull recommended that amortization of HSE's excess ADIT not begin until HSE's next base rate case and recommended that ADIT be included as a zero-cost source of capital in HSE's capital structure. Ms. Stull also recommended HSE be required to correct its tax accounting in its 2018 and 2019 IURC annual reports to reflect appropriate deferred tax balances and that these amended reports be filed within 60 days of the issuance of a final order in this proceeding.

Ralph C. Smith, a Senior Regulatory Consultant with Larkin & Associates PLLC, explained that he was retained by the OUCC to review historical information provided by HSE on book and tax depreciation and to provide a calculation of the amount of related ADIT. Mr. Smith calculated that HSE has ADIT related to book-tax depreciation differences of approximately $155,000 for the period September 2010 through December 31, 2017. Using Ms. Stull's post-TCJA S corporation tax rate of 23.31%, Mr. Smith calculated an excess ADIT amount of $20,000, as shown in his Attachment LA-2. Mr. Smith testified that if the Commission finds excess ADIT as of December 31, 2017, any such excess ADIT related to the use of accelerated federal income tax depreciation would be classified as "protected" and must follow Internal Revenue Service normalization requirements. He explained that due to HSE's relatively small excess ADIT amount of $20,000, Ms. Stull recommended that HSE not be required to amortize excess ADIT until its next rate case and that such a recommendation does not violate normalization rules.

C. Respondent's Rebuttal. Mr. Krohn disagreed with Ms. Stull's recommendation that HSE's Phase 1 income tax expense, as updated by the TCJA, be based on an S corporation status for several reasons. He explained that HSE is no longer an S corporation but is instead a C corporation effective January 1, 2018, and that such a change was made in response to the TCJA. According to Mr. Krohn, HSE remaining an S corporation is no longer beneficial to HSE's ratepayers due to the significantly lower C corporation tax rate that went into effect due to the TCJA. Mr. Krohn also disagreed with Ms. Stull's conclusion that the tax rate applicable to HSE under an S corporation status would be significantly lower than the 26.82% combined tax rate approved by the Commission in Cause No. 44683. He testified that Ms. Stull's analysis mistakenly excludes CIAC from taxable income, even though CIAC is now taxable income due to the TCJA, and that Ms. Stull incorrectly concluded that HSE's shareholders would be eligible for the QBI deduction. According to Mr. Krohn, it is not appropriate for the OUCC to apply the part of the TCJA that lowers HSE's income but then ignore the part of the TCJA that taxes CIAC and places HSE's shareholders in higher tax brackets.

Mr. Krohn accepted Ms. Stull's conclusion that the amount of income tax expense currently embedded in HSE's rates is $172,117 and that the effective blended tax rate approved by the Commission in Cause No. 44683 is actually 25.85%,[2] not the stated tax rate of 26.82%. Mr. Krohn also accepted, for purposes of this proceeding, that the difference between the income tax expense currently embedded in HSE's rates and the income tax expense as a result of the TCJA based on HSE's current C corporation status is $984. Mr. Krohn testified that he continues to believe that an income tax expense amount based on a C corporation status results in the greatest benefit to HSE's customers. According to Mr. Krohn, HSE's rates would need to be adjusted to reflect the tax difference of $984, which results in a rate reduction of 0.0083% based on current C corporation tax rates.

Regarding the Phase 2 issues, Mr. Krohn disagreed with Ms. Stull's conclusion that HSE over-collected income tax expense in the amount of $192,300 as of May 31, 2020. According to Mr. Krohn, Ms. Stull's calculation of the over-collected amount (*i.e.,* regulatory liability) is based on an improper calculation that uses an S corporation status. Mr. Krohn updated his regulatory liability calculation shown in his Attachment OWK-4 to reflect the Phase 1 tax difference amount of $984 (or a rate reduction of 0.0083%) based on HSE's current C corporation status, which results in a revised regulatory liability amount of $2,955.73. Mr. Krohn agreed that an update to this amount through the date HSE implements its adjusted Phase 1 rates would be appropriate if the Commission deems the revised regulatory liability amount to be material enough for reconciliation. Mr. Krohn also agreed that it was reasonable to refund the revised regulatory liability amount of $2,955 over a 12-month period, but he disagreed that such a refund period would be appropriate if the Commission finds the regulatory liability owed to HSE's customers to be significantly higher.

Mr. Krohn also disagreed with the OUCC's recommendations regarding ADIT. According to Mr. Krohn, the calculation of excess ADIT based on book versus tax depreciation accounting differences is a ratemaking issue that should have been raised in Cause No. 44683 or can be addressed in a future rate case. He testified that it is not appropriate for the Commission to make the ADIT findings recommended by the OUCC in this proceeding. Mr. Krohn agreed with the OUCC's recommendation that HSE be required to update its 2018 and 2019 annual reports to the Commission to reflect excess ADIT.

[2] The effective rate calculated by Ms. Stull is actually 25.83%.

Mr. Mares responded to the OUCC's recommendation that the income tax expense to be embedded in HSE's rates should be $108,374 based upon a combined tax rate of 23.31%. Mr. Mares disagreed with Ms. Stull's assertion that inclusion of CIAC in HSE's taxable income is inconsistent with how book versus tax differences were treated in Cause No. 44683. According to Mr. Mares, because the TCJA was not in effect when the Commission issued its final order in Cause No. 44683, there are many differences between how income tax expense was calculated then and how it should be calculated now. He testified that all impacts of the TCJA must be considered and claimed that the OUCC was arbitrarily picking and choosing which components of the TCJA should be applied to HSE. Mr. Mares explained that to determine the tax rate applicable to HSE's shareholders based on their taxable income, you must include CIAC because it is now taxable income because of the TCJA. Mr. Mares testified that he continues to believe the correct taxable income amount for determining the federal income tax rate for HSE's shareholders using an S corporation status is the $1,663,756 calculated in his Attachment ABM-1, which includes HSE's 2014 CIAC amounts.

Mr. Mares disagreed with the OUCC's conclusion that HSE's shareholders would qualify for the QBI deduction. He explained that HSE's income would be considered qualified business income under the Internal Revenue Code and therefore eligible for the QBI deduction if all of the other QBI deduction requirements have been met. According to Mr. Mares, calculation of the QBI deduction on an individual's tax return is subject to various limitations. He explained that the most significant limitation for HSE's shareholders is the taxable income thresholds established by the TCJA. Mr. Mares explained that the QBI deduction is ratably phased out when taxable income exceeds certain thresholds and provided an example of how the deduction is gradually reduced as taxable income increases.

Using HSE's shareholders' 2014 tax returns, Mr. Mares determined that only one HSE shareholder would partially qualify for the QBI deduction based on each shareholder's 2014 taxable income unadjusted for the TCJA. Mr. Mares explained that if you adjust each shareholder's 2014 taxable income to include CIAC, none of HSE's shareholders would be eligible for the QBI deduction. Mr. Mares disagreed with Ms. Stull's recommendation that HSE's income be isolated for purposes of determining whether the QBI deduction applies. He explained that HSE's income cannot be isolated because eligibility for the QBI deduction is based on the shareholder's total taxable income. According to Mr. Mares, the eligibility thresholds for the QBI deduction would become irrelevant if you were to isolate just HSE's income, which is not contemplated by the TCJA. Mr. Mares concluded that the appropriate tax rate to be used under an S corporation income tax expense analysis is the combined tax rate of 28.84% shown in his Attachment ABM-1, which includes CIAC as taxable income and excludes the QBI deduction due to none of HSE's shareholders being eligible for the deduction.

4. Commission Discussion and Findings.

A. Phase 1. HSE performed two Phase 1 income tax expense calculations. The first calculation was based on HSE's conversion to a C corporation, which occurred after its base rates were set in Cause No. 44683 and was effective January 1, 2018. The second calculation used the S corporation income tax methodology approved by the Commission in Cause No. 44683 but updated for the TCJA's impacts (*i.e.*, all impacts of the TCJA including CIAC as taxable income). HSE asserted the purpose of the two calculations is to support HSE's belief that an income tax expense calculation based on HSE's current C corporation status provides the greatest benefit to its customers.

HSE concluded that an income tax expense calculation based on its current C corporation status would result in a slight rate reduction to its base rates and charges, while an income tax expense calculation based on its prior S corporation status would result in no rate reduction. HSE found the combined tax rate under its updated S corporation analysis to be 28.84%, which is higher than the 26.82% tax rate approved by the Commission in Cause No. 44683. The difference in the tax rate used in HSE's calculations is primarily due to the inclusion of $989,081 of CIAC in taxable income to HSE's shareholders if HSE were still an S corporation.

The OUCC questioned the appropriateness of considering HSE's decision to convert to a C corporation, noting the purpose of this investigation is to address effects of the TCJA and the TCJA did not require HSE to convert to a C corporation. The OUCC also identified several errors in HSE's income tax calculations and proposed excluding CIAC from any income tax expense calculation because income tax expense for ratemaking purposes should be based on HSE's book taxable income, which does not include CIAC. In support of its recommendations, the OUCC performed Phase 1 calculations regarding: (1) the income tax expense currently embedded in HSE's rates; (2) the difference between the income tax expense currently embedded in HSE's rates and the post-TCJA income tax expense based upon HSE's C corporation status; and (3) an S corporation calculation that isolates HSE's income, applies the QBI deduction to all of HSE's shareholders, and excludes CIAC from taxable income. Based on its calculations, the OUCC disagreed that an income tax expense calculation based on a C corporation status results in the greatest rate reduction.

On rebuttal, HSE agreed with the OUCC's C corporation calculations and the amount of income tax expense currently embedded in HSE's rates. However, HSE disagreed with the OUCC's conclusions regarding: (1) its post-TCJA S corporation income tax expense calculation; (2) the inclusion of CIAC in HSE's shareholders' taxable income for purposes of determining the appropriate tax rate applicable to HSE's shareholders; and (3) whether HSE's shareholders qualify for the QBI deduction and the isolation of HSE's income for purposes of determining whether the QBI deduction requirements have been met. HSE concluded that its initial S corporation calculation was correct and consistent with the TCJA.

We first address the parties' disagreement as to whether HSE's income tax expense revenue requirement should be calculated using C corporation or S corporation income tax rates. Our January 3, 2018 Order (at p. 1) in Cause No. 45032 initiating this investigation stated that the TCJA "contains provisions reducing the corporate tax rate of 35% to 21% and revising the federal tax structure." In addition, "[t]he current rates being charged by most, if not all, of Indiana's jurisdictional rate-regulated, investor-owned utilities were approved … and include recovery of costs incorporating the federal corporate tax rate of up to 35%." *Id*. In setting the scope of this investigation, we also stated, "the purpose of this investigation is to review and consider the impacts from the [TCJA] and how any resulting benefits should be realized by customers." *Id*. at 2. Moreover, our February 16, 2018 Order (at p. 2) in that same Cause established the proper Phase 1 process for calculating revised rates and charges to reflect the new 21% corporate income tax as a result of the TCJA in the revenue requirement for federal income tax:

> The revised Rates and Charges shall be designed to remove the difference between (1) the amount of federal taxes that the given Rate or Charge was designed to recover based on the tax rate in effect at the time the Rate or Charge was approved, and (2) the amount of federal taxes that would have been embedded in the given Rate or Charge

had the new tax rate applicable to Respondent as a result of the [TCJA] been in effect at the time of approval.

Using HSE's C corporation status as the basis for its federal income tax revenue requirement is inconsistent with our stated intention and purpose of the tax investigation. HSE's conversion from an S corporation to a C corporation was not a requirement or provision of the TCJA, but rather a decision made by HSE's shareholders and management. While HSE witnesses' state that this decision was motivated by the TCJA, this does not change the fact that it was not a requirement of the TCJA itself. Accordingly, we find that for purposes of this proceeding, HSE's federal income tax revenue requirement as calculated in its last base rate case, which was based on its S corporation status, should be updated to reflect the TCJA income tax rate.[3]

While we agree with the OUCC that the federal income tax revenue requirement should be calculated based on HSE's S corporation status, we agree with HSE that all aspects of the TCJA, including that related to CIAC, must be considered in computing the income tax rate applicable to HSE's shareholders. As an S corporation, HSE is not taxed at the corporate level. Instead, its shareholders are responsible for income taxes based on each shareholder's proportionate share of HSE's income. The TCJA made CIAC taxable income for investor-owned wastewater utilities such as HSE, and therefore an S corporation calculation updated for the TCJA must now include CIAC as income for the purpose of determining HSE's shareholders' combined tax rate. If HSE were still an S corporation, its shareholders would be paying income taxes based upon their entire taxable income that includes CIAC, which affects the individual shareholders' tax brackets for purposes of determining HSE's income tax expense under the S corporation methodology used in HSE's last base rate case.

As for the QBI deduction, we agree with HSE that its income cannot be isolated in determining whether the QBI deduction applies for tax purposes and compliance with federal tax laws. However, we agree with the OUCC that the Commission has the authority to determine how taxes will be calculated for ratemaking purposes. In Cause No. 43761, the Commission established the method for determining HSE's income taxes to be included in rates and determined that the tax on HSE's earnings should be isolated from other income earned by each shareholder. *Hamilton Southeastern Utilities, Inc.*, Cause No. 43761 at 23 (IURC Aug. 18, 2010). Accordingly, we find that HSE's income should be isolated for purposes of determining whether the QBI deduction applies.

Consequently, based on the evidence presented, when CIAC is included in income and HSE's income is isolated from other shareholder income, we find that four of the eight shareholders are eligible for a QBI deduction. As shown in the table below, this results in a 30.66% tax rate, which is higher than the 26.82% rate approved in HSE's current base rates, and therefore no rate reduction is required as a result of the TCJA.

[3] Even if we used HSE's current C corporation status to determine its federal income tax expense, the parties calculated an income tax expense difference of $984 for a rate reduction of 0.0083%, which we find to be immaterial.

Calculated Based on S corporation Filing Status Using Respective 2018 Tax Rates including QBI deduction

Proposed Net Income Before Income Tax Expense	$ 1,103,026
Add: Cash CIAC	735,250
Property CIAC	253,831
Taxable Income before QBI Deduction	$ 2,092,107

Actual filing status from 2018 tax return>>>>	**MFJ**	**MFJ**	**MFJ**	**HOH**	**MFJ**	**MFJ**	**Trust**	**Trust**		
Allocated income %'s >>>>	**25.00%**	**25.00%**	**6.25%**	**6.25%**	**6.25%**	**6.25%**	**12.50%**	**12.50%**		
	Shareholder (Sh.) 1	**Sh. 2**	**Sh. 3**	**Sh. 4**	**Sh. 5**	**Sh. 6**	**Sh. 7**	**Sh. 8**	**Total - All Shareholders**	
Pro forma net utility operating income before income tax before QBI	$ 523,027	$ 523,027	$130,757	$130,757	$130,757	$ 130,757	$ 261,513	$ 261,513	**$ 2,092,107**	
Less: QBI deduction ($315,000 threshold married filing joint, $157,500 all others)	-	-	26,151	26,151	26,151	26,151	-	-	**104,605**	
Pro forma net utility operating income before income tax	523,027	523,027	104,605	104,605	104,605	104,605	261,513	261,513	**1,987,502**	i
Calculated federal tax using 2018 applicable tax rates	$ 134,438	$ 134,438	$ 14,892	$ 18,003	$ 14,892	$ 14,892	$ 95,147	$ 95,147	**$ 521,850**	ii
Federal Income Tax Rate	25.70%	25.70%	11.39%	13.77%	11.39%	11.39%	36.38%	36.38%	***26.26%***	ii / i
							State Income Tax Rate		***4.4%***	
						Stated Combined Income Tax Rate			***30.66%***	

After updating HSE's rates schedules with the combined tax rate and reducing the income tax expense expected to be collected from developers through HSE's cost option one election for main contributions and through its System Development Charge for cash contributions, we find no rate reduction is warranted.

	Final Order CN 44683	Updated Final Order Per OUCC	Updated Final Order Per IURC
Original Cost rate Base	$ 5,142,991	$ 5,142,991	$ 5,142,991
Times: Weighted Cost of Capital	9.60%	9.60%	9.60%
Net Operating Income Required for Return on Rate base	493,727	493,727	493,727
Less: Adjusted Net Operating Income	397,635	433,870	372,918
Net Revenue Requirement	96,092	59,857	120,809
Add: Gross-Up for Taxes	144.9702%	14,560	461,938
Less: Taxes Paid by Developers and SDCs			408,183
Recommended Revenue Increase	$ 139,305	$ 74,417	$ 174,564
Recommended Percentage Increase	1.17%	0.63%	1.47%

	Year Ended 12/31/2014	Adjustments	*Pro forma* Present Rates	Adjustments	*Pro forma* Proposed Rates
Operating Revenues	$ 11,008,500	$ 998,179	$ 12,006,679	$ 174,564	$ 12,181,243
O&M Expense	9,713,220	116,831	9,830,051	642	9,830,693
Depreciation Expense	137,893	32,260	170,153		170,153
Amortization Expense	139,098	(139,098)	-		-
Taxes Other Than Income					
Payroll Tax	29,782	2,338	32,120		32,120
Property Tax	1,276,746	971	1,277,717		1,277,717
Utility Receipts Tax	152,346	15,296	167,642	8,074	175,716
Utility Receipts Tax paid by developers/SDCs			-	(5,636)	(5,636)
Income Taxes:					
Federal Income Tax		132,802	132,802	389,048	521,850
Federal Income Tax paid by developers/SDCs			-	(346,026)	(346,026)
State Income Tax		23,276	23,276	64,174	87,450
State Income Tax paid by developers/SDCs			-	(56,521)	(56,521)
Total Operating Expenses	11,449,085	184,676	11,633,761	53,755	11,687,516
	$ (440,585)	$ 813,503	$ 372,918	$ 120,809	$ 493,727

B. Phase 2. Phase 2 of this proceeding addresses any over-collection of income tax expense prior to the TCJA and the refund of that overcollection to customers. Based on its calculation of C corporation tax liability, HSE determined that it over-collected $2,956 in excess federal income tax from customers from January 1, 2018 through May 2020. The OUCC's calculation of HSE's federal income tax regulatory liability, which is based on S corporation income tax rates, resulted in an over-collection of $192,300 in federal income taxes from January 1, 2018 through May 31, 2020. Based on our determination above that under either a C corporation or an S corporation analysis, HSE's tax expense would be higher after the TCJA than what is currently embedded in rates, there is no over-collection of income tax expense and no refund required.

Phase 2 also addresses the determination of excess ADIT and the appropriate ratemaking treatment related thereto. HSE asserted that because it was an S corporation prior to the TCJA, it has not historically had any ADIT balances. However, as explained by the OUCC, ADIT is not created by a utility's corporate status but is the result of differences between book taxable income and taxable income for tax purposes. The primary driver of ADIT is the difference between book and tax depreciation expenses due to the use of accelerated depreciation. Although HSE as an S corporation did not pay taxes directly and did not record income tax expense or ADIT, ADIT exists because HSE's shareholders deducted tax depreciation on their tax returns while book depreciation was used in the determination of rates. This timing difference generates deferred income taxes. Because HSE received authorization to recover income tax expense through customer rates in Cause No. 43761, the period for determining ADIT should be the period from August 18, 2010, the date of the Commission's Order in Cause No. 43761, to January 1, 2018, the date of the TCJA. Accordingly, we find that HSE shall develop an ADIT balance starting from August 18, 2010, which should be addressed in its next base rate case.

Regarding the amount of excess ADIT, because of our determination above that HSE's S corporation tax rate due to the TCJA is higher than the tax rate embedded in HSE's rates, we find there is no excess ADIT to refund to customers.

Finally, the OUCC recommended that HSE be required to correct its tax accounting in its 2018 and 2019 IURC annual reports to reflect appropriate deferred tax balances and that these amended reports be filed within 60 days of the issuance of a final order in this proceeding. HSE agreed to this recommendation. Therefore, HSE is directed to provide amended 2018 and 2019 annual reports to the Commission within 60 days of this Order reflecting appropriate deferred tax balances.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. Under Phase 1 of the Commission's investigation, no reduction to HSE's rates and charges is required as a result of the TCJA.

2. HSE shall address its ADIT balance in its next base rate case.

3. HSE shall file amended 2018 and 2019 annual reports as instructed above within 60 days of this Order.

4. This Order shall be effective on and after the date of its of approval.

HUSTON, FREEMAN, KREVDA, OBER AND ZIEGNER CONCUR:

APPROVED: JAN 06 2021

I hereby certify that the above is a true and correct copy of the Order as approved.

Mary M. Schneider

Digitally signed by Mary M. Schneider
Date: 2021.01.06 10:11:44 -05'00'

Mary M. Schneider
Secretary of the Commission