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October 9, 2020
INDIANA UTILITY
REGULATORY COMMISSION

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 2 FOR HAMILTON SOUTHEASTERN UTILITIES, INC.	**)))))))**	**CAUSE NO. 45032 S16**

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR'S SUBMISSION OF STIPULATED CROSS-EXAMINATION EXHIBIT

The Office of Utility Consumer Counselor ("OUCC"), by counsel, hereby submits OUCC CX-1, a cross-examination exhibit to which Respondent, Hamilton Southeastern Utilities, Inc. ("HSE") has stipulated into the evidentiary record without objection. The OUCC makes this submission consistent with Paragraph 2 of the Presiding Officers' October 7, 2020 docket entry in this Cause.

Respectfully submitted,

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

Tiffany T. Murray, Attorney No. 28916-49
Deputy Consumer Counselor

CERTIFICATE OF SERVICE

Indiana Office of Utility Consumer Counselor's Submission of Stipulated Cross-Examination Exhibit has been served upon the following parties of record in the captioned proceeding by electronic service on October 9, 2020.

Randolph L. Seger
Michael T. Griffiths
DENTONS BINGHAM GREENEBAUM LLP
2700 Market Tower
10 West Market Street
Indianapolis, Indiana 46204
E-mail:randy.seger@dentons.com
michael.griffiths@dentons.com

Tiffany T. Murray
Deputy Consumer Counselor

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR
115 West Washington Street
Suite 1500 South
Indianapolis, IN 46204
infomgt@oucc.in.gov
317/232-2494 – Phone
317/232-5923 – Facsimile

Q-2-14: What is Mr. Mares' understanding of the IRS normalization requirements as they relate to CIAC?

Objection: HSE objects to the Data Request on the basis of the foregoing general objections.

Response: Prior to 2018, HSE was structured as an S corporation and therefore the company did not pay corporate taxes. All taxes were paid at the shareholder level and no deferred taxes were reflected on HSE's financial statements prior to 2018.

With that said, in general, normalization is a system of accounting used by regulated public utilities to reconcile the tax treatment of accelerated depreciation of public utility assets allowable under IRC Sec. 168 with their regulatory treatment. Under the normalization rules, a utility must make adjustments to a reserve to reflect the deferral of taxes resulting from the difference between the amount of depreciation used to determine the utility's Federal income tax liability and the amount of depreciation used to compute regulated tax expense. The IRS' normalization rules are as follows:

Internal Revenue Code - 168(i)(9) Normalization Rules

168(i)(9)(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)—

168(i)(9)(A)(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

168(i)(9)(A)(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.

The IRS has stated that the normalization rules otherwise applicable to CIAC property do not have to be applied if the following four conditions are satisfied: (1) The CIAC is included in the utility's taxable income; (2) The utility uses the noninclusion method of accounting for CIAC; (3) The federal income tax attributable to the receipt of the CIAC is not taken into account in determining cost of service; and (4) The contributor pays the utility an additional amount that is reasonably intended to indemnify or reimburse the utility for the prepayment of tax resulting from receipt of the CIAC (i.e., the utility receives a CIAC that is "grossed-up" for tax). If a CIAC satisfies these four conditions, neither the utility nor the ratepayers (except for the contributor) are affected by the prepayment of taxes that results from receipt of the CIAC. Thus, it is not necessary to normalize a "grossed-up" CIAC to carry out the purposes of the normalization rules. A utility may, therefore, use MACRS depreciation for federal income tax purposes, regardless of whether the "grossed-up" CIAC is normalized. See Accounting for Public Utilities, page 17-62 (Attachment A to the OUCC's 2nd Data Request); IRS Cumulative Bulletin Notice 87-82 (December 3, 1987).

HSE, under current tax laws, satisfies all four conditions. Regarding condition four (4), there appears to be a misunderstanding about who pays the "grossed-up" tax for CIAC. HSE has always elected IURC cost option #1 where the developer (i.e., the contributor) pays the taxes on CIAC including the grossed-up amount. See HSE's rules and regulations approved in Cause No. 44683. HSE has never requested a change to this cost option election.

Q-2-15: According to Accounting for Public Utilities (see Attachment A), the "noninclusion method" of accounting for CIAC is appropriate when CIAC is not recognized when measuring the cost of service – the receipt of CIAC is not included in rate base or depreciated for cost of service:

> If a utility uses the noninclusion method of accounting for CIAC….the IRS maintains that the effect is equivalent to including the CIAC in income in the year of receipts, and depreciating the related CIAC property in its entirety in the same year. Thus, a utility using the non-inclusion method of accounting for CIAC will be treated for purposes of the normalization rules as if it computed its regulated tax expense by depreciating the related CIAC property in its entirety in the year in which the CIAC is received.
>
> If a utility uses a non-inclusion method of accounting for CIAC, it must debit (i.e., decrease) accumulated deferred taxes on its regulated books of account by the temporary difference of tax resulting from the taxable receipt of the CIAC.
>
> Accounting for Public Utilities, Chapter 17 – Accounting for Taxes, §17.07[2] (Attachment A).

How does Mr. Mares' rebuttal testimony, in which he states at page 2, line 17 that "you must include CIAC because it is now taxable income" reconcile with the "noninclusion method" of accounting for CIAC?

Objection: HSE objects to the Data Request on the basis of the foregoing general objections.

Response: Mr. Mares' rebuttal testimony only relates to the calculation of an effective tax rate if HSE were an S corporation and the impact the TCJA had on this tax rate. Under the TCJA, CIAC is now considered to be taxable income, which affects the effective tax rate. Mr. Mares does not address how CIAC is to be handled for ratemaking purposes.

Publication Table of Contents

ACCOUNTING FOR PUBLIC UTILITIES

VOLUME 1

ACCOUNTING FOR PUBLIC UTILITIES

Volume 1

ROBERT L. HAHNE

GREGORY E. ALIFF

DELOITTE & TOUCHE LLP

Contributing Authors: The following were the original contributing authors of Accounting for Public Utilities. While much of what these individuals originally wrote has been removed or replaced through the annual update process, we wish to continue to recognize their contributions in the creation of this book.

FRANCIS J. ANDREWS, JR.
WILLIAM W. EYERS
JOHN S. FERGUSON
HERNAN GONZALEZ
JOHN D. MCCLELLAN
RICHARD W. MCCULLOUGH
JAMES E. MORRIS
RANDALL A. SNOWLING
JAN A. UMBAUGH

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CHAPTER 17

Accounting for Taxes

SYNOPSIS

§ 17.01 Interperiod Income Tax Allocation

[1] Background

Certain transactions may affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income in a different reporting period. Thus, revenues or gains and expenses or losses may be included in the determination of taxable income either earlier or later than they are included in pre-tax accounting income. Therefore, the amount of income taxes determined to be payable for a period does not necessarily represent the appropriate income tax expense applicable to the transactions recognized for financial accounting purposes in that period.

The problem of properly matching income tax expense with accounting income is resolved through an accounting process known as interperiod tax allocation or deferred income tax accounting. Interperiod tax allocation involves the allocation of tax expense among various accounting periods. The organizations that set accounting standards have concluded that interperiod tax allocation is necessary to account for the tax effects of transactions that involve temporary differences. Thus, accounting principles generally accepted in the United States of America (GAAP) require that a provision for deferred taxes be made to account for the tax effects of temporary differences. In the utility industry, this practice is referred to as normalization.

Interperiod tax allocation, or normalization, is based on the premise that the taxes recorded in the income statement for a given accounting period should be related (or matched) to the revenues and expenses recorded in the books for the same period. The fact that revenues or expenses would be recognized for tax purposes in a period earlier or later than that in which they are accounted for in the books requires the recording of an income tax cost increase (or decrease) to offset the decrease (or increase) in taxes

[2] Contributions in Aid of Construction

Before the enactment of the TRA 1986, the IRC provided a special rule for contributions in aid of construction (CIACs) received by regulated public utility providers of electric, gas, water or sewage services.[110] CIACs were not included in a public utility's taxable income and, therefore, were not subject to taxation. Instead, this provision of the former tax law thus permitted public utilities to treat CIACs as nontaxable contributions to capital.[111]

The TRA 1986 repealed the provisions pertaining to CIACs, effective for all amounts received after December 31, 1986.[112] Thus, under present law, CIACs must be taxed as ordinary income and the property purchased with these funds can be depreciated for tax purposes.

[a] Relocation Payments

The TRA 1986 raised a particular question on the proper characterization of relocation payments received by natural gas and electric utilities for federal income tax purposes. Utilities typically receive relocation payments when the activities of a third-party necessitate the relocation of some of the utility's distribution plant. For natural gas and electric distribution companies, this situation frequently arises when a highway construction project requires the removal or relocation of existing distribution lines. Under prior law, the relocation payments were treated as tax-free contributions to capital for federal income tax purposes and were not included in the utility's taxable income.

After enactment of the TRA 1986, however, the question arose whether utilities could continue to treat the receipt of these relocation payments as a nontaxable CIAC. Unless the transaction fell within one of the special nonrecognition provisions of the IRC, it was unclear whether the utility would be required to recognize income (for federal income tax purposes) currently on the receipt of the relocation payments.

The IRS has announced that certain relocation payments received by a utility are not includable in taxable income.[113] The IRS explained that the legislative history to the TRA 1986 indicates that the repeal of the special provision for CIACs was not intended to affect transfers of property that are not made "in connection with the provision of services" including those situations in which the transfer was made for "the benefit of the public as a whole." Therefore, transfers of this type will continue to be treated as a nontaxable contribution to capital under present law. Thus, the IRS ruled that reimbursement payments for the relocation of the gas lines received on

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[110] See IRC § 118(b)(1954).

[111] However, prior tax law also provided that no income tax deductions were allowable for CIACs. Thus, property purchased with CIACs could not be depreciated for tax purposes, nor could any ITC be claimed on such property. See IRC § 362(c)(3)(1954).

[112] Pub L No 99-514, 99th Cong, 2d Sess (Oct 22, 1986) at § 824.

[113] See Notice 87-82, 1987-2 CB 389.

behalf of a school district is a nonshareholder contribution to a capital and is not a taxable CIAC.[114]

Other examples of transfers that continue to qualify as capital contributions include relocation payments received pursuant to a government program for placing utility lines underground for the purposes of community esthetics or public safety and not for the direct benefit of any particular class of the utility's customers. If a property transfer fails to qualify as a nontaxable contribution to capital, the transfer may still be treated in accordance with one of the special nonrecognition provisions in the IRC if it falls within one of these provisions. Two special nonrecognition provisions in the IRC may be useful to utilities. These are:

(1) IRC Section 1033, which allows taxpayers to defer the recognition of gain from involuntary conversions (including condemnations or sales under threat of condemnation); and

(2) IRC Section 1031, which requires taxpayers to defer the recognition of gain or loss from a like-kind exchange.

[b] Interconnections of Power Plants and Transmission Grids

Notice 2001-82[115] extends the safe harbor provisions of Notice 88-129[116] (covering transfers of interties from a qualifying facility (QF) to a regulated public utility) to include transfer of interties to utilities from independent power producers and other stand-alone generators that are not QFs. The revised safe harbor provisions apply to transfers completed after December 24, 2001. The intertie must be used exclusively to transmit power across the utility's transmission grid for sale to customers or intermediaries. Furthermore, the safe harbor provisions are extended to long-term (i.e., ten years or more) interconnection agreements, not just long-term power purchase contracts. Title to the electricity must transfer from the generator prior to transmission of the transmission utility's grid. Intertie transfers covered by the notices do not result in taxable contribution in aid of construction income to the transmission utility.

[c] Smart Grid Investment Grants

The United States Department of Energy (DOE) has awarded grants to certain applicants for their qualifying investments in smart electric meters and other smart electric grid property under the Smart Grid Investment Matching Grant Program as authorized by section 1306 of the Energy Independence and Security Act of 2007[117] as amended by section 405, Division A of the American Recovery and Reinvestment Act of 2009.[118] Revenue Procedure 2010-20[119] provides a safe harbor resulting in

[114] Ltr Rul 200048026.

[115] 2001-2 CB 619.

[116] 1998-2 CB 541.

[117] Pub L No 110-140.

[118] Pub L No 111-5.

[119] 2010-1 CB 528.

exclusion of such grants from the taxable income of corporate recipients that properly reduce the basis of their property as required by IRC Section 362(c) and the regulations thereunder. This safe harbor does not apply to noncorporate recipients or smart grid technology research, development or demonstration grants.

[d] Clean Coal Grants

The United States Department of Energy (DOE) and the National Energy Technology Laboratory (NETL) has issued awards for clean coal technology made under three different programs under ARRA 2009. Revenue Procedure 2011-30[120] provides a safe harbor resulting in exclusion of such awards from the taxable income of corporate recipients that properly reduce the basis of its property as required by IRC Section 362(c) and the regulations thereunder. In addition, the revenue procedure states that the safe harbor does not apply to the portion of the award paid or incurred for non-capital expenditures (such as operating expense) or for research and experimental expenditures under IRC Section 174.

[e] Universal Service Fund

The exclusion of non-capital expenditures is consistent with subsidies made by federal and state governments to telecommunication carriers under a universal service support program are includible in the carrier's gross income and not contribution to capital. Court case rulings have affirmed the treatment of government subsidies as taxable income in situations where the telecommunication carriers received payments from the Federal Communications Commission (FCC) Universal Service Fund (USF).[121] The payments were intended to supplement lost revenue from servicing high-cost and low-income subscribers and not supplement the cost of capital improvements.

[f] Valuation of CIACs

The IRS has issued general guidelines for the valuation of CIACs received by a public utility.[122] The IRS states that a utility should include in taxable income the amount of any cash received or the fair market value of any property received as CIACs. The fair market value of property is normally equivalent to its "replacement cost" to the utility. Whether an asset is in rate base for ratemaking purposes is of no effect in the determination of its fair market value.

In various transactions involving CIAC transfers, the CIAC element must be evaluated and quantified for federal income tax purposes. Thus, if there is a sale of property to a utility at less than fair market value, the CIAC is equal to the bargain element in the sale (i.e., the amount by which the fair market value of the property exceeds the purchase price). Similarly, if a loan is made to a utility at a "below-market" interest rate, the benefit to the utility of the below-market interest rate is a

[120] 2011-1 CB 802.

[121] See U.S. V. Coastal Utilities, Inc. 514 F.3d 1184 (11th Cir. 2008), AT&T, Inc. v. U.S., 629 F.3d 505 (5th Cir. Jan 4, 2011), and Sprint Nextel Corp. v. United States, No. 09-2325 (D. Kan. Mar 4, 2011).

[122] See Notice 87-82, 1987-2 CB 389.

taxable CIAC. Any transaction in which a utility effectively obtains the burdens and benefits of property is treated as a CIAC, even if legal title to that property is held by a customer, a governmental agency, or another person. This rule is intended to prevent utilities from circumventing the federal income tax law by having legal title to the CIAC property retained by the customer or some other third party. Transactions resembling a CIAC transfer but for the retention of legal title by a person or entity other than the utility will, therefore, be subject to careful scrutiny by the IRS to determine whether the utility has effectively obtained the burdens and benefits of ownership as a result of the transaction. The IRS considers the following questions in making this determination.

(1) Is the utility responsible for maintaining the property?

(2) Does the utility, in effect, have unrestricted access to, and control of, the property?

(3) Does the utility bear legal liability in case of a malfunction or accident involving the property?

[g] Normalization Requirements for CIACs

In order to comply with the MACRS normalization rules under IRC Section 168, it is necessary for utilities to use a normalization method of accounting for CIAC property.[123] Because taxable CIAC property is depreciated for federal income tax purposes, book/tax temporary differences arise and must be normalized in accordance with the MACRS normalization rules under IRC Section 168.

For regulatory accounting purposes, utilities typically exclude the receipt of CIAC from their regulated books of account and do not include the CIAC or CIAC property in income, cost of service, or rate base. (See Chapter 4.) The Uniform System of Accounts (USOA) for electric and gas utilities does not include an account for the CIAC. The USOA for water/waste water systems does include a CIAC account. The recorded CIAC, however, may not be recognized when measuring the cost of service. This method is referred to as the "noninclusion method" of accounting for CIAC. If a utility uses the noninclusion method of accounting for CIAC (i.e., if the receipt is not included in rate base or depreciated for cost of service), the IRS maintains that the effect is equivalent to including the CIAC in income in the year of receipt, and depreciating the related CIAC property in its entirety in the same year. Thus, a utility using the noninclusion method of accounting for CIAC will be treated for purposes of the normalization rules as if it computed its regulated tax expense by depreciating the related CIAC property in its entirety in the year in which the CIAC is received.

If a utility uses a noninclusion method of accounting for CIAC, it must debit (i.e., decrease) accumulated deferred taxes on its regulated books of account by the temporary difference of tax resulting from the taxable receipt of the CIAC. Moreover, as the CIAC property is depreciated for federal income tax purposes, further adjustments must be made to the liability for deferred taxes as these temporary differences reverse.

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[123] See Notice 87-82, 1987-2 CB 389.

In some jurisdictions, although any recorded CIAC may not be included in rate base, depreciation of CIAC property is included in cost of service for ratemaking purposes. The IRS has not specifically addressed the proper normalization accounting methodology to be used in these cases. Presumably, however, if depreciation expense were included in cost of service for ratemaking purposes (e.g., by not offsetting the expense with an equal amount of CIAC amortization), it would not be correct to treat the CIAC property as if it were fully depreciated (i.e., for book accounting) in the year of receipt. Therefore, when depreciation of CIAC property is included in a utility's cost of service for ratemaking purposes, it would not be appropriate to reduce the deferred tax liability by the taxes payable for the CIAC received. Instead, the CIAC property in this case would be normalized in a manner similar to any other public utility property.

The IRS has stated that the normalization rules otherwise applicable to CIAC property do not have to be applied if the following four conditions are satisfied:

(1) The CIAC is included in the utility's taxable income;

(2) The utility uses the noninclusion method of accounting for CIAC;

(3) The federal income tax attributable to the receipt of the CIAC is not taken into account in determining cost of service; and

(4) The contributor pays the utility an additional amount that is reasonably intended to indemnify or reimburse the utility for the prepayment of tax resulting from receipt of the CIAC (i.e., the utility receives a CIAC that is "grossed-up" for tax).

If a CIAC satisfies these four conditions, neither the utility nor the ratepayers (except for the contributor) are affected by the prepayment of taxes that results from receipt of the CIAC. Thus, it is not necessary to normalize a "grossed-up" CIAC to carry out the purposes of the normalization rules.[124] A utility may, therefore, use MACRS depreciation for federal income tax purposes, regardless of whether the "grossed-up" CIAC is normalized.

The IRS ruled that reversing negative deferred taxes which would decrease rate base violates the accelerated depreciation normalization requirements of IRC Section 168(f)(2), even if the utility did not actually receive the taxes associated with the CIACs from contributors.[125]

[h] Treatment of CIACs by Utility Customers

When a CIAC contributor (e.g., a customer, real estate developer) makes a CIAC to a utility, the creation of an intangible asset having a useful life extending substantially beyond the close of the contributor's tax year results. Therefore, the CIAC must be capitalized and cannot be deducted as a current period expense.[126] In the case of a real estate developer or home builder who incurs the CIAC for property primarily held for

[124] See Notice 87-82, 1987-2 CB 389.

[125] Ltr Rul 9035056.

[126] See Notice 87-82, 1987-2 CB 389.

sale to customers in the ordinary course of business, the intangible asset (i.e., the amount of the CIAC) should be allocated to the tax basis of the property being held for sale to customers. Thus, the CIAC will ultimately reduce the amount of taxable gain recognized by the developer or home builder when the property is sold.

In the case of a CIAC contributor who is a utility customer, the CIAC creates a separate intangible asset and, therefore, must also be capitalized. A CIAC payment by an electric generation company to a transmission company to facilitate interconnection of a power plant to the transmission grid must be capitalized as an intangible asset and recovered using the straight-line method over a useful life of 20 years.[127] In the case of other CIAC contributions by utility customers, whether the intangible asset created may be amortized and, if so, the applicable amortization period depends on the facts and circumstances of the arrangement.

[i] Special Rules for Water and Sewerage Disposal Utilities

The Small Business Job Protection Act of 1996[128] amended IRC Section 118 for water and sewerage utilities. A CIAC made to a water or sewerage disposal regulated public utility of water or sewerage disposal facilities is treated as a contribution to the utility's capital. The contribution is not included in gross income if the amount is not included in the taxpayer's rate base for ratemaking purposes.

Also not included in gross income are amounts regulated public utilities receive that meet the expenditure rule. The expenditure rule is met if the amount is expended for the acquisition or construction of tangible IRC Section 1231 property that is of the same type used predominantly in the trade or business of furnishing water or sewerage disposal services if the expenditure occurs before the end of the second tax year after the year in which the utility received the amount. The amendment to IRC Section 118 applies to amounts received after June 12, 1996.[129]

[3] Deduction for Manufacturing Activities

The American Jobs Creation Act of 2004 (AJCA)[130] enacted IRC Section 199, which permits a phased-in tax deduction of up to 9 percent of qualified production activities income. Generally, for 2010 and beyond, a taxpayer may deduct 9 percent of the lessor of: (1) qualified production activities income or (2) taxable income. Such deduction is limited, however, to 50 percent of the W-2 wages paid by the taxpayer during the calendar year.

Qualified production activities income is an amount that is computed according to the following formula: domestic production gross receipts less the sum of:

(1) the cost of goods sold with respect to those receipts;

(2) other deductions, expenses or losses directly allocable to such receipts; and

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[127] Notice 2001-82, 2001-2 CB 619.

[128] Pub L No 104-188, 104th Cong 2d Sess § 1613(a)(1) (Aug 20, 1996).

[129] See IRC § 118(c) and (d).

[130] Pub L No 108-357.