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 INDIANA AMERICAN WATER COMPANY, INC	)	CAUSE NO. 45032 S4

OUCC LATE-FILED EXHIBIT NO. 1

Q-1. The Commission noted on page 40 of its Final Order in Cause No. 44022 (6/6/12) that "[b]oth of the expert tax witnesses in this proceeding were in agreement that normalization is the appropriate regulatory treatment of timing tax differences such as those that are created by accelerated depreciation and the repairs method change." However, both tax experts in this case appear to believe that repairs deductions are a basis difference and not a timing difference (see Petitioner witness Wilde's rebuttal testimony, page 9 and OUCC witness Smith's testimony, page 13). Please provide a detailed explanation, along with any supporting documentation, regarding what appears to be a change in both parties position regarding repairs deductions.

OUCC RESPONSE:

There is no change in OUCC witness Smith's position. Deferred income tax accounting continues to be appropriate for regulatory accounting for repairs deductions. Moreover, in terms of evaluating the regulatory treatment of the amounts of excess Accumulated Deferred Income Taxes ("EADIT") for public utilities such as Indiana-American, the EADIT related to repairs deductions is a basis difference, not a method/life difference, and therefore is properly classified as unprotected, and the Commission therefore has discretion as to how the repairs EADIT is amortized.

OUCC's understanding of the reference to "normalization" in Cause No. 44022 relates to the regulatory treatment of the income tax effect of repairs deductions. In that Cause, both tax experts recommended that deferred income tax accounting, as opposed to flow-through accounting, be used. Because the repairs deductions reduces Current Income Tax Expense, the "normalization" in Cause No. 44022 related to applying deferred income tax accounting and debiting Deferred Income Tax Expense and crediting an Accumulated Deferred Income Tax account for the impact of the repairs deductions. As such, Accumulated Deferred Income Taxes were generated through deferred income tax accounting for the cumulative effect of the change in tax accounting for repairs (which is being referred to as the §481(a) adjustment) and from the difference between the current year federal tax deduction for repairs and the book expense for repairs.

The reference to "normalization" in Cause No. 44022 is not the same as the normalization issue contested in this subdocket, which is whether the excess Accumulated Deferred Income Taxes (EADIT) related to repairs deductions are "protected" (i.e., are required to be amortized or normalized using an Average Rate Assumption Method ("ARAM")) under the Internal Revenue Code or whether the repairs-related EADIT is "unprotected" and can thus be amortized on a straight-line basis and over a period that is shorter than the remaining useful life of the utility's public utility property. Because repairs deductions are not tax depreciation for federal income tax purposes, deferred income tax accounting for repairs deductions is not required under the Internal Revenue Code. As discussed above, utilities can and some have been "flowing through" repairs deductions, i.e., not recording a debit for Deferred Income Tax Expense and crediting an Accumulated Deferred Income Tax to account for the impact of the repairs deductions. Because the repairs deductions are substantial, many regulators have required their utilities to apply deferred income tax accounting for repairs for regulatory accounting purposes.

For federal income tax purposes, repairs deductions are governed by §162 and 263 and the Treasury Regulations such as those in §1.162-4(a) and §1.263(a)-3. Repairs deductions are an ordinary and necessary business expense deduction for federal income tax purposes. Repairs deductions are not tax depreciation and are not reported on the tax depreciation form (form 4562) and do not appear on the tax depreciation line of the federal corporate income tax return (form 1120). The related costs for the tax repairs deductions are not capitalized as part of the tax basis of the asset. Consequently, the amounts claimed as repairs deductions do not become part of the tax basis of the asset and no tax depreciation is therefore claimed on repairs deductions. Thus, the repairs deductions are referred to as a "basis difference" since the deductions are claimed in the tax year in which the repairs are made, and do not become part of the tax basis of the asset upon which tax depreciation is applied. The tax basis of the asset is depreciated for federal income tax purposes under Internal Revenue Code Section 168 but no income tax depreciation is taken on repairs deductions because no amounts for repairs deductions are included in the tax basis of the assets upon which tax depreciation is calculated.

Normalization requirements of the Internal Revenue Code are contained in §168 and the related Treasury regulations under §1.168 and relate to the use of accelerated tax depreciation. Accelerated tax depreciation involves the use of shorter cost recovery periods (i.e., "life" differences) and accelerated tax depreciation methods (i.e., "method" differences) (e.g., double declining balance for tax versus straight line for book). The normalization requirements of the Internal Revenue Code relate to tax depreciation, which generally has a shorter life than book depreciation and which generally uses an accelerated method in contrast with book depreciation, which generally uses straight line. Other than bonus tax depreciation, the Modified Accelerated Cost Recovery System (MACRS) is applied for purposes of calculating tax depreciation. MACRS reflects generally shorter lives than book depreciation. MACRS also uses accelerated methods for cost recovery than book depreciation which typically uses a straight line method. These differences between tax and book depreciation are referred to as "method/life" differences. It is generally recognized by utility income tax departments and by most, if not all utilities, that the Internal Revenue Code normalization requirements under Internal Revenue Code section 168 relate to tax depreciation and specifically to "method/life" differences. Repairs deductions are not made under Internal Revenue Code 168 and do not generate tax depreciation and are therefore not subject to such normalization requirements for federal income tax purposes.

In response to OUCC DR 04-015 (see, e.g., OUCC Attachment LA-3, page 19 of 48), Indiana-American admitted that once a deduction for repairs is taken under Section 162 of the Internal Revenue Code, the amount of that deduction (1) cannot be added to the tax basis of the property and (2) cannot be depreciated for federal income tax purposes under Section 168 of the Internal Revenue Code. The tax repairs deduction is a reduction in arriving at the tax basis and is not depreciated for federal income tax purposes.

The OUCC's position in this subdocket, as explained in Mr. Smith's testimony and herein, is that the repairs-related EADIT is unprotected and the amortization of all unprotected EADIT, which includes but is not limited to repairs EADIT, is up to the discretion of the regulator. Under federal income tax normalization requirements, the ARAM is required to be applied to EADIT related to method/life differences which are related to federal income tax depreciation. In contrast, unprotected EADIT related to repairs deductions is a basis difference, and the regulator can therefore require the utility to amortize EADIT for repairs on a straight-line basis and over a period determined to be appropriate by the regulator, including a period such as three or five years. The use of a shorter amortization period and a straight-line basis for amortizing unprotected EADIT related to repairs does not cause a federal income tax normalization violation, and is in fact currently being done by many utilities in response to actions taken by regulatory commissions as a consequence of the Tax Cuts and Jobs Act of 2017.

Q-2. Page 3 of Respondent's Attachment JRW-2 states the following: Under the taxpayer's present method of accounting for repair and maintenance costs, the taxpayer capitalizes the repair and maintenance costs described above and recovers these costs using the appropriate method over the applicable recovery period and the applicable convention as prescribed by§ 168(a). Under the taxpayer's proposed method of accounting for repair and maintenance costs, the taxpayer will treat the repair and maintenance costs as ordinary and necessary business expenses pursuant to§§ 162 and 1.162-4.

Based on these Consent Agreement statements, does the $256,280,025 reflected on OUCC 04-001 Attachment represent the amount of repairs that were capitalized for tax purpose before the method change in accounting that resulted based on the Consent Agreement Fact referenced above? If not, please provide a detailed description of what the $256,280,025 represents.

OUCC RESPONSE:

It appears not, based on the Company's responses to OUCC discovery asking about the $256,280,025 amount. In response to OUCC DR 05-001(b), which has been included in OUCC Attachment LA-3 at page 27 of 48, the Company stated that the $256,280,025 "is not isolated to tax repairs deductions claimed, it is net bonus and accelerated tax depreciation deductions that were part of 481(a) adjustments." In that response, the Company stated further that: "In practice, any tax repairs deductions claimed reduces tax basis so that tax depreciation is only calculated on the remaining basis."

Additionally, in response to OUCC DR 05-001(a), the Company stated the $256,280,025 amount (i.e., the "T105: Repairs" item from the Company's response to OUCC 4-1) includes "gross tax repair deduction in excess of book repair deductions claimed for 2001-2017, plus and minus bonus depreciation deduction and accumulated tax depreciation deductions claimed prior to each change in the Company's method of accounting that were included in 481(a) adjustment."

Q-3. In Respondent witness Wilde's testimony, page 7, he references Paragraph 9 of the Consent Agreement (Attachment JRW-2) that states the following:

> **9) If any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(1)(3)(A):**
>
> **(A) A normalization method of accounting (within the meaning of § 168(i)(9), former §168(e)(3)(B), or former § 168(1)(3)(G), as applicable) must be used for such public utility property.**

Please provide a detailed explanation that supports how the Repairs listed in line item T105 of OUCC 04-001 Attachment meets the definition of Internal Revenue Code §168(i)(10).

OUCC RESPONSE:

It does not. While Indiana-American's property is generally considered to be "public utility property," no repairs deductions are claimed, nor can they be claimed, under Internal Revenue Code §168 as tax depreciation on public utility property, so the Accumulated Deferred Income Taxes related to repairs deductions are not required to have a normalization method of accounting (within the meaning of § 168(i)(9), former §168(e)(3)(B), or former § 168(1)(3)(G), as applicable). Perhaps more importantly, an Average Rate Assumption Method ("ARAM") based amortization is not required for the Excess Accumulated Deferred Income Taxes ("EADIT") related to repairs (i.e., the EADIT for repairs is properly classified as "unprotected" as it has been by numerous utilities) and the amortization period to be applied for the repairs EADIT is therefore subject to the discretion of the regulatory commission. Therefore, an ARAM-based amortization need not be applied to repairs EADIT and a regulatory commission such as the IURC has discretion over the amortization of repairs EADIT and can determine that the EADIT for repairs should be amortized on a straight-line basis over a period that is shorter than the remaining useful life of the public utility property.

Respectfully Submitted,

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Deputy Consumer Counselor

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing ***Office of Utility Consumer Counselor's OUCC Late-Filed Exhibit No. 1*** has been served upon the following counsel of record in the captioned proceeding by electronic service on December 10, 2018.

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