



# Utility Income Tax Concepts

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# SafeHarbor

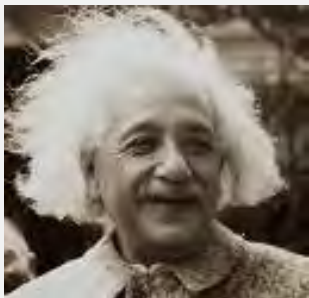


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# Agenda



**“The hardest thing in the world to understand is the income tax.”**

**Albert Einstein**



# Agenda

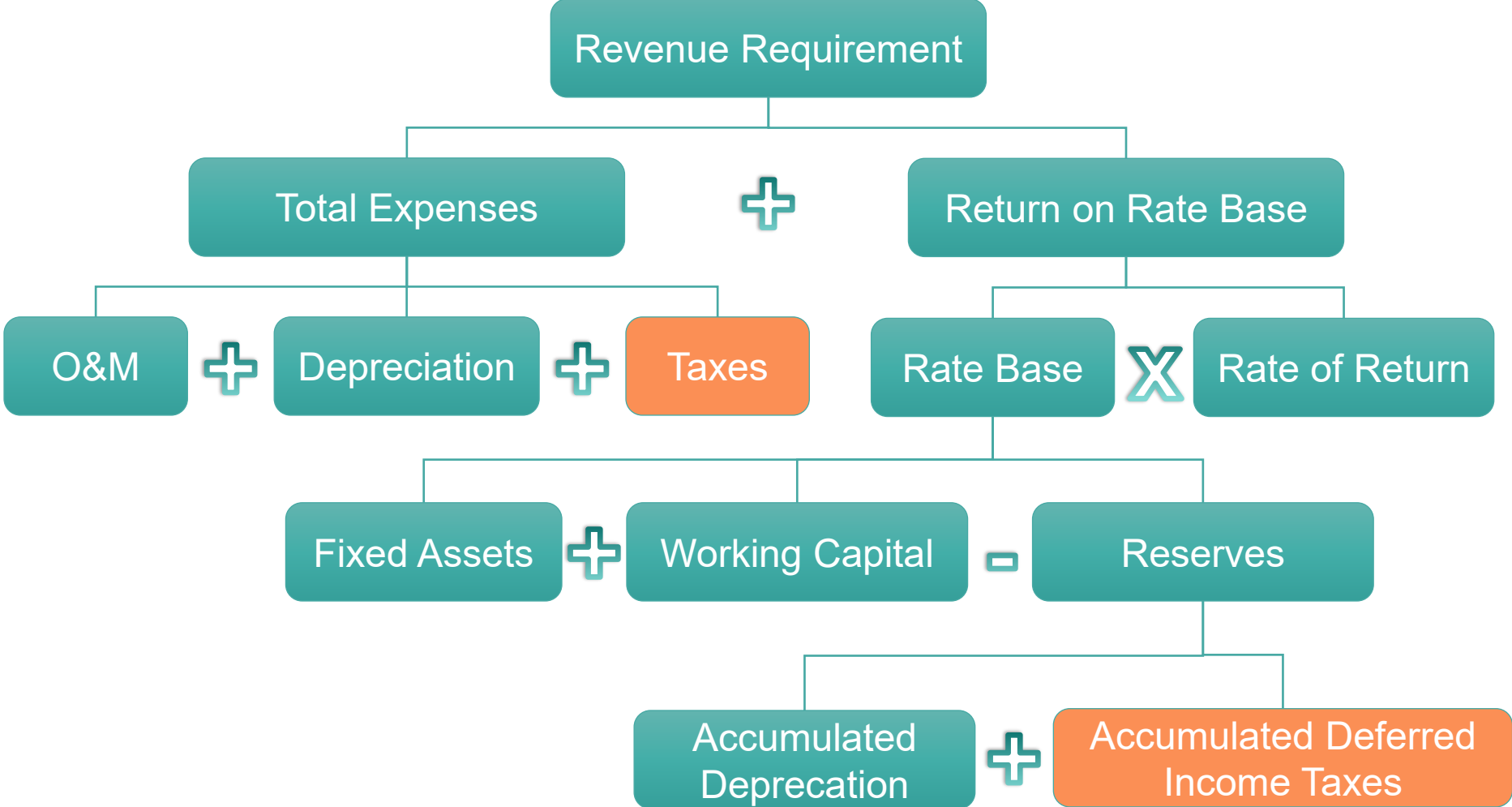
- Overview of Ratemaking Formula
- Review of Basic Utility Income Tax Calculation
- Review of Example of Ratemaking Income Tax Calculation
- Interest Synchronization
- Deferred Income Taxes and Normalization vs. Flow Through
- Changes in Federal Income Tax Rates and Impact on Utilities
- Bonus Depreciation
- Inflation Reduction Act of 2022
- IRS Developments
- FERC Developments
- Repair Deduction



# Overview of Ratemaking Formula



# Ratemaking Formula



# Ratemaking Formula



- Allows operating expenses, including income taxes, to be recovered on a dollar for dollar basis in revenue requirements.
- Most state commissions and the Federal Energy Regulatory Commission (FERC) allow recovery of both current and deferred income taxes in income tax expense.
- Accumulated Deferred Income Taxes (ADIT) is an interest free loan from the government. ADIT is treated by Commissions as either a Rate Base reduction or as zero-cost capital in the ratemaking formula. Either treatment serves to reduce revenue requirements.
  - Treatment as zero cost capital lowers the overall allowed return
  - Treatment as a Rate Base offset reduces Rate Base and a lower return will be produced in the Rate Base x return part of the ratemaking formula

# Review of Basic Utility Income Tax Calculation





# Utility Tax Expense Calculation



PIPELINE COMPANY, LLC		
Tax Expense Calculation		
Twelve Months Ended August 31, 2024, As Adjusted		
Line No.	Description	Total (a)
1	Revenues	68,338,167
	<u>Operating Expenses</u>	
2	Operations and Maintenance	\$ 12,036,748
3	Administrative & General	5,406,529
4	Depreciation Expense	35,923,619
5	Taxes Other Than Income	533,421
6	Total Operating Expenses	53,900,317
7	Operating Income	14,437,850
8	Less: Interest Expense	(1,418,252)
9	Taxable Income	13,019,598
10	State Income Taxes @ 2.2828%	297,207
11	Federal Taxable Income	12,722,391
12	Federal Income Taxes @ 21%	2,671,702
13	Net Income After Taxes	\$ 10,050,689

Revenues – Operating Expense – Interest = Pre-Tax Book Income

Note that state income taxes are computed and are a deduction to arrive at Federal Taxable Income

This computation focuses on total tax expense.

Deferred taxes and permanent items will be discussed later.

Twelve Months Ended August 31, 2024, As Adjusted

# Effective Income Tax Rate

<b>Effective Income Tax Rate</b>		
Taxable Return		100.0000%
State Tax Rate - Gross		2.2828%
Federal Taxable Return		97.7172%
Federal Rate		21.0000%
Effective Federal Rate		20.5206%
Combined Effective Rate		22.8034%

<b>Proof of Combined Effective Tax Rate</b>		
Taxable Income		13,019,598
Combined Effective Rate		22.8034%
Total Taxes		2,968,909
Federal Taxes		2,671,702
State Taxes		297,207
Total Taxes for Revenue Requirements		2,968,909

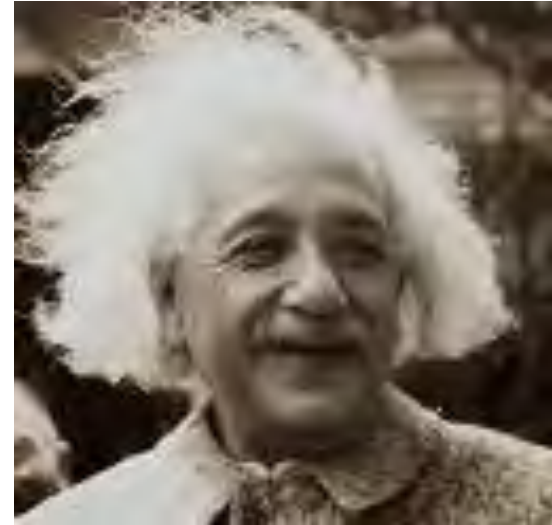
The effective income tax rate shows the overall percent income tax rate as a percentage of taxable income

Using the numbers from the Tax Calc on the prior page you can see that the effective tax rate is properly calculated.

## Poll Question

According to Einstein, what is the hardest thing in the world to understand?

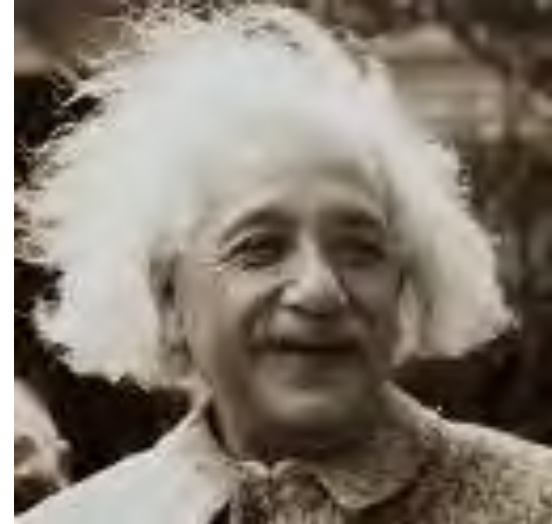
1. Speed of Light
2. Quarks
3. Income taxes
4. Time



## Poll Question

According to Einstein, what is the hardest thing in the world to understand?

1. Speed of Light
2. Quarks
3. **Income taxes**
4. Time



# Review of Ratemaking Income Tax Calculation



# Ratemaking Tax Expense Calculation

PIPELINE COMPANY, LLC			STATEMENT H-3
Income Taxes			
Twelve Months Ended August 31, 2024, As Adjusted			
Line No.	Description	Reference	FIT at 21% Total (a)
	<u>Federal Income Tax</u>		
1	Return on Rate Base at 12.13%	STATEMENT B	\$ 11,468,939
	<u>Federal Income Tax Adjustments</u>		
2	Interest and Debt Expense	Schedule I-1(c), Page 10	(1,418,252)
3	Deficient Deferred State Income Taxes	Schedule H-3(2)	-
4	Net FIT Adjustment		(1,418,252)
5	Return after FIT Adjustments		10,050,687
6	Federal Income Taxes @ 21% Tax Gross Up Rate of 26.5823%		\$ 2,671,702
7	State Taxes - Net of Federal Benefit Gross up of 2.3361%		\$ 297,207

Note that in ratemaking the exercise in this example starts with Overall Return on Rate Base multiplied by Rate Base

Since interest is a component of the overall return, this amount is deducted to arrive at Equity Return.

A tax gross up is applied to convert the computed tax expense into a revenue requirement.

# Income Tax Rate Gross-Up

<b>Grossed Up Effective Rate</b>		
Taxable Return		100.0000%
State Tax Rate - Gross		2.2827692%
Federal Taxable Return		97.7172%
Federal Rate		21.0000%
Effective Federal Rate		20.5206%
Combined Effective Rate		22.8034%
Grossed Up Effective Rate		29.5394%
Return		10,050,687
Grossed Up Effective Rate		29.5394%
Total Taxes		2,968,909
Federal Taxes		2,671,702
State Taxes		297,207
Total Taxes for Revenue Requirements		2,968,909

The Grossed Up Effective rate is 1 divided by (1 minus the Combined Effective Rate)

$$\text{Gross up} = \frac{\text{Amount}}{1 - \text{Tax Rate}}$$

Note that the sum of the Federal and State Taxes equals the Total Taxes for the Revenue Requirement Calculation.

# Schedule of Total Cost of Service for Ratemaking

PIPELINE COMPANY, LLC			Statement A
Cost of Service			
Twelve Months Ended August 31, 2024, As Adjusted			
			FIT at 21%
Line No.	Description	Reference	Total (a)
<u>Operating Expenses</u>			
1	Operations and Maintenance	STATEMENT H-1	\$ 12,036,748
2	Administrative & General	STATEMENT H-1	5,406,529
3	Total Operating Expenses		17,443,277
4	Depreciation Expense	STATEMENT H-2	35,923,619
5	Taxes Other Than Income	STATEMENT H-4	533,421
6	Return @ 12.13%	STATEMENT B	11,468,939
7	Federal Income Taxes	STATEMENT H-3	2,671,702
8	State Income Taxes	STATEMENT H-3	297,207
9	Revenue Credits	SCHEDULE G-5	(6,003,276)
10	Total		\$ 62,334,889

This schedule summarizes the total cost of service for this pipeline

Note that the Basic Tax Calculation we did previously is based on this Cost of Service.

Also note that the total Revenue Requirement is \$62,334,889 for base rates plus \$6,003,276 of revenue credits for a sum of \$68,338,167. All other amounts translate over to the calculation on a one for one basis.





# Interest Synchronization



# Capital Structure



PIPELINE COMPANY, LLC							
Resulting Return on Common Equity From Overall Rate of Return Claimed							
Twelve Months Ended August 31, 2024, As Adjusted							
<u>Line</u>	<u>Description</u>	<u>Capitalization</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Rate</u>	<u>Return Component</u>	<u>Rate of Return on</u>
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
<u>No.</u>							
1	Overall Rate of Return Claimed					12.13%	
2	Debt	\$ 916,305	21.26%	7.07%	1.50%		
3	Common Equity	\$ 3,393,648	78.74%	13.50%	10.63%		13.50%
4	Total	\$ 4,309,953			12.13%		

This schedule supports both the equity return and the overall return.

Remember that interest expense attributable to debt is deductible for purposes of taxable income

# Interest Synchronization Calculation



PIPELINE COMPANY, LLC			
Rate Base and Return			
Twelve Months Ended August 31, 2024, As Adjusted			
Line No.	Description	Reference	Total (a)
1	Plant	STATEMENT C	\$ 635,680,122
2	Accumulated Provision for Depreciation	STATEMENT D	(503,830,579)
3	Net Plant		131,849,543
4	Accumulated Deferred Income Taxes	Schedule B-1	(38,017,968)
5	Regulatory Assets	Schedule B-2	-
6	Working Capital	STATEMENT E	718,620
7	Rate Base		\$ 94,550,195
8	Return on Rate Base at 12.13%		\$ 11,468,939
9	Synchronized Interest at 1.50%		\$ 1,418,253

Formula for Interest Synchronization

Weighted Average Cost of Debt x  
Rate Base = Synchronized Interest

# Ratemaking Tax Expense Calculation

PIPELINE COMPANY, LLC			STATEMENT H-3
Income Taxes			
Twelve Months Ended August 31, 2024, As Adjusted			
Line No.	Description	Reference	FIT at 21% Total (a)
	<u>Federal Income Tax</u>		
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For reference the interest used in the tax expense calculation is based on the interest synchronization calculation on the previous slide



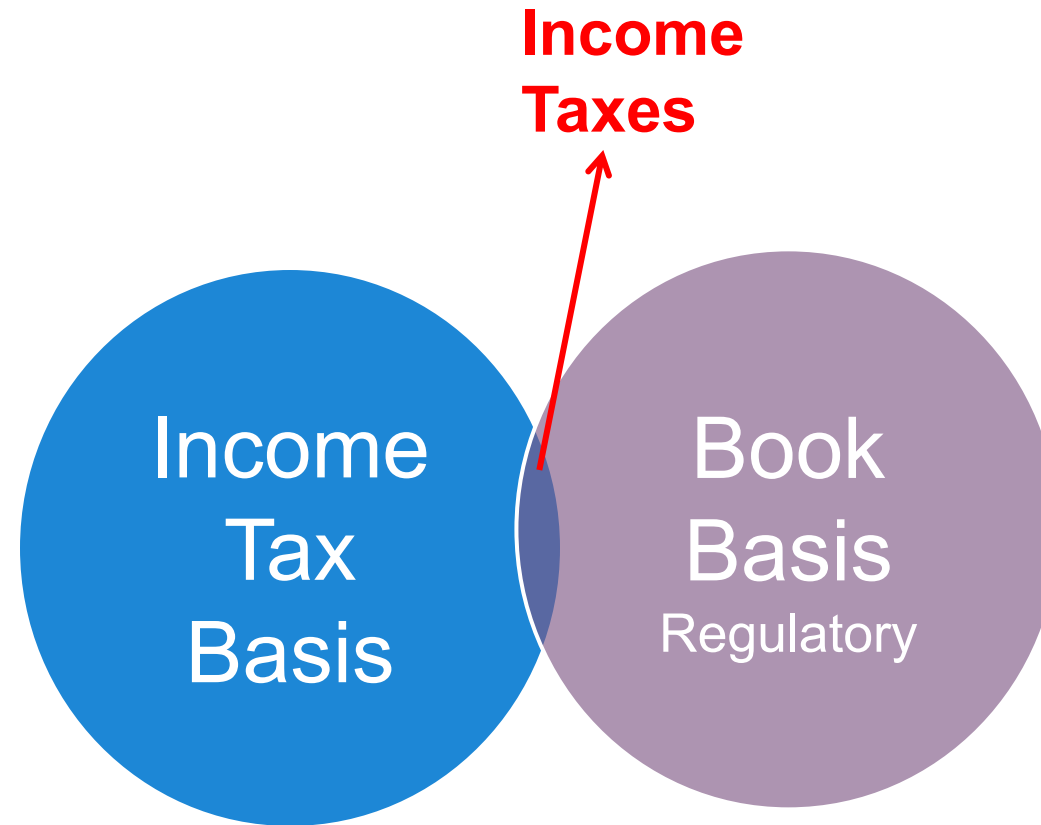
# Deferred Income Taxes and Normalization versus Flow-Through

# Income Tax Computation

## A Simple Example

Revenue	1,000,000
Expenses	(600,000)
Depreciation	(200,000)
Interest	(100,000)
Taxable Income	<u>100,000</u>
Income Tax 21% Tax Rate	(21,000)
Net Income	<u>79,000</u>

# Basis of Accounting



# Income Tax Computation

## A Simple Example

	Tax Basis	Regulatory Basis
Revenue	1,000,000	1,000,000
Expenses	(600,000)	(600,000)
Depreciation	(200,000)	(100,000)
Interest	(100,000)	(100,000)
Taxable Income	<u>100,000</u>	<u>200,000</u>
Income Tax 21% Tax Rate	(21,000)	(42,000)
Net Income	<u>79,000</u>	<u>158,000</u>



# Income Tax Computation

## A Simple Example

	Tax Basis	Regulatory Basis
Revenue	1,000,000	1,000,000
Expenses	(600,000)	(600,000)
Depreciation	(200,000)	(100,000)
Interest	(100,000)	(100,000)
Taxable Income	<u>100,000</u>	<u>200,000</u>
Income Tax 21% Tax Rate	(21,000)	(42,000)
Net Income	<u>79,000</u>	<u>158,000</u>

# Timing Difference



- A difference between book income and tax income that originates in one period and reverses (or turns around) in one or more later periods
- Some timing differences effectively reduce income taxes that would otherwise be payable currently;
- Whereas, the effect of others increase income taxes that would otherwise be payable currently.

# Income Tax Computation

## Classified Format

	Tax Basis	Regulatory Basis
Revenue	1,000,000	1,000,000
Expenses	(600,000)	(600,000)
Depreciation	(100,000)	(100,000)
Interest	<u>(100,000)</u>	<u>(100,000)</u>
Total Expenses	<u>(800,000)</u>	<u>(800,000)</u>
Book Income before Tax Basis Adjustments	200,000	200,000
Statutory Adjustments (Schedule M)		
Depreciation:		
Flow-through	-	-
Normalized	(100,000)	-
Taxable Income	<u>100,000</u>	<u>200,000</u>
Income Tax 21% Tax Rate	(21,000)	(42,000)
Net Income	<u>79,000</u>	<u>158,000</u>

# Normalization



The application of tax law can result in a deduction or revenue item being included in a different year than the year in which the same deduction or revenue item will be reflected for rate making (regulatory) purposes.

The income tax effect associated with the timing difference between book and tax income is deferred.

# Flow-through

The opposite of normalization is referred to as flow-through.

Flow-through accounting is the recording of income tax expense based on “actual current taxes paid.”

Flow-through accounting requires that income taxes be expensed “as paid,” even if there is a mismatch between tax return income and book income.

# Journal Entry

## COMPREHENSIVE INTERPERIOD TAX ALLOCATION Also know as NORMALIZATION

	Dr	Cr	
Income Tax Expense	42,000		
Income Tax Payable		21,000	} 42,000
Deferred Income Tax		21,000	

# Journal Entry

## Flow-Through Accounting

### Recovery in Rates of only the amount Paid

	Dr	Cr	
Income Tax Expense	21,000		
Regulatory Asset – Flow Through	26,582		
		Income Tax Payable	21,000
		Deferred Income Tax	26,582
			47,582

\* Note that the Regulatory Asset is subject to gross-up at the 21% Rate

#### Proof of Deferred Income Tax –

Flow through difference	100,000
Regulatory Asset – Flow through	<u>26,582</u>
Total	126,582
Tax Rate	<u>21%</u>
Required Deferred Income Tax	26,582

# Schedule of the Computation of Deferred Taxes

Year	Book Depreciation	MACRS Tax Depreciation	Timing Difference	Deferred Tax	Cumulative Deferred Tax
1	66,667	100,000	(33,333)	(7,000)	(7,000)
2	66,667	180,000	(113,333)	(23,800)	(30,800)
3	66,667	144,000	(77,333)	(16,240)	(47,040)
4	66,667	115,200	(48,533)	(10,192)	(57,232)
5	66,667	92,160	(25,493)	(5,354)	(62,586)
6	66,667	73,728	(7,061)	(1,483)	(64,068)
7	66,667	65,536	1,131	237	(63,831)
8	66,667	65,536	1,131	237	(63,594)
9	66,667	65,536	1,131	237	(63,356)
10	66,667	65,536	1,131	237	(63,119)
11	66,667	32,768	33,899	7,119	(56,000)
12	66,667		66,667	14,000	(42,000)
13	66,667		66,667	14,000	(28,000)
14	66,667		66,667	14,000	(14,000)
15	66,667		66,667	14,000	0
	1,000,000	1,000,000	0	0	



# Deferred Income Taxes – Normalization Versus Flow Through History

- Internal Revenue Code of 1954 first allowed accelerated depreciation. Many Commissions required flow-through treatment of benefits.
- IRS first promulgated normalization rules with respect to the investment tax credit under IRC Section 38 - General business credit
- Following the passage of the Revenue Act of 1962, several federal regulatory agencies mandated the flow-through of the tax benefits of the ITC to ratepayers. Congress imposed rules (non-codified) on federal agencies restricting flow-through given *the purpose of the tax benefit was to stimulate investment, not reduce rates for utility customers.*
- Tax Reform Act of 1969 extended normalization requirements to the tax effect of accelerated depreciation.
- Economic Recovery Tax Act of 1981 (IRC Section 167) ended flow through accounting *for depreciation.*

# Deferred Income Taxes – Normalization



- Basic Normalization
  - Use the same depreciation method for computing ratemaking income tax expense as use for computing depreciation expense for revenue requirement purposes
  - Any difference between ratemaking and IRS tax expense is put into or taken out of a reserve account
  - The reserve ([Accumulated Deferred Income Taxes](#)) may be treated as either a reduction to rate base or as zero cost capital in the capital structure for purposes of setting rates

# Deferred Income Taxes – Failure to Normalize



If normalization rules are violated

- The utility is no longer permitted to use accelerated depreciation for computing IRS tax payments.
- Go-forward basis only, is not applied retroactively

# Deferred Income Taxes – Ratemaking Options



- Rate Base Deduction
  - The balance of the Accumulated Deferred Income Taxes are deducted from rate base
  - Funds were not provided by investors so investors should not earn a return on any investments derived from the use of these funds
  
- Cost Free Capital
  - The balance of the Accumulated Deferred Income Taxes are treated as an element of the capital structure, at a zero cost
  - Funds are available for the utility's use without an attached interest rate or required return

# Deferred Income Taxes – Ratemaking



	<u>Zero Cost Capital</u>	<u>Reduced Rate Base</u>
Other Rate Base	\$1,000	\$1,000
ADIT Reduction	<u>\$ 0</u>	<u>\$ 100</u>
Total Rate Base	\$1,000	\$ 900
Debt	\$500 @ 6.5%	\$500 @ 6.5%
Equity	\$400 @ 10%	\$400 @ 10%
ADIT	<u>\$100 @ 0%</u>	<u>\$ 0 @ 0%</u>
Total	7.25%	8.055%
Return on Rate Base	<b>\$72.50</b>	<b>\$72.50</b>

# Deferred Income Taxes – AFUDC Equity



- Book / Regulatory
  - Allowance for Funds Used During Construction (AFUDC) is frequently capitalized and becomes part of the cost of the long-lived asset
  - Represents capitalized interest and equity costs
  - Reflects the *after-tax* equity costs associated with construction
  - Will be recovered over the life of the asset through depreciation
- Tax
  - Equity portion of AFUDC is never recognized by IRS in determination of taxable income
  - Depreciation reflecting the capitalized equity is not recognized by IRS in determination of taxable income
  - Item will generate additional book-basis income tax expense because of the non-deductible equity AFUDC depreciation

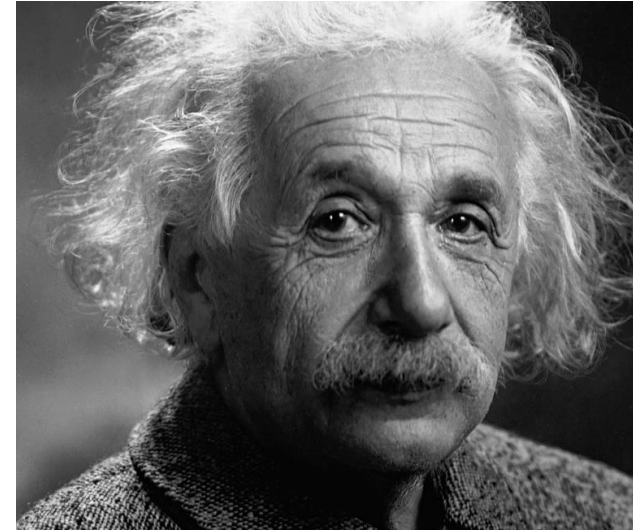
# Deferred Income Taxes – AFUDC Equity

- Book – Tax Difference for AFUDC Equity is Considered a Temporary Difference
  - Deferred Tax Liability is created for the basis difference created by different treatment
  - “Grossed Up” Regulatory Asset is created when there is probable future recovery of the future income taxes related to this book-tax difference

## Poll Question

If a utility company is found to be in violation of IRS normalization requirements, this happens!

1. Loss of accelerated depreciation §168
2. Nothing
3. They must pay a penalty
4. All the above

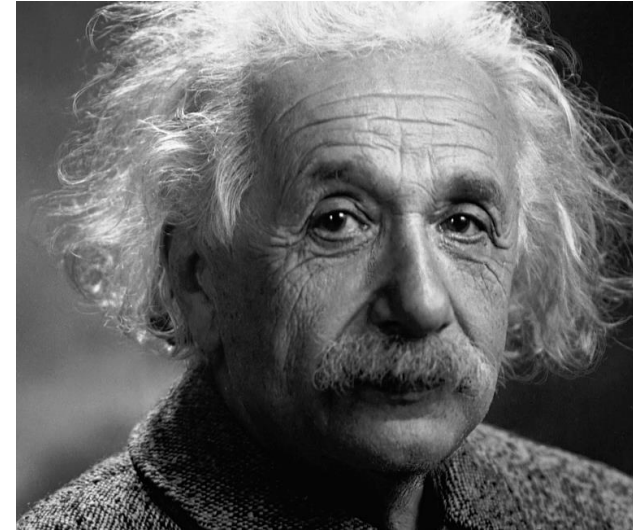




## Poll Question

If a utility company is found to be in violation of IRS normalization requirements, this happens!

1. Loss of accelerated depreciation §168
2. Nothing
3. They must pay a penalty
4. All the above





# Permanent Items



# Permanent Differences



- Permanent Differences
- A transaction that is reported for book purposes but cannot (and will never be able to) deduct for tax purposes
  - Penalties and Fines
  - Meals and Entertainment (50% deductible for tax)
  - Life Insurance Premiums and Proceeds
  - Club Dues
- Should be reflected in the regulatory tax expense calculation to the extent the related cost or activity is a utility operating expense.

# Permanent Differences



- Permanent Differences
- Many the same transactions, though are reported for book purposes, are NOT included in the revenue requirement as recoverable costs from ratepayers.
  - Penalties and Fines
  - Meals and Entertainment (50% deductible for tax)
  - Life Insurance Premiums and Proceeds
  - Club Dues



# Changes in Income Tax Rates and Impact on Utilities



# First Major Reduction in Tax Rates – Tax Reform Act of 1986



## Tax Reform Act of 1986

- Introduced MACRS System
- Reduced Corporate Tax Rate
  - 46% to 34%
  - Resulted in “Excess” deferred income tax reserves
  - Prior book/tax differences created reserve at older, higher rates that would reverse in period of lower rates
  - PUCs wanted a windfall reversal of excess deferrals on balance sheets to customers
  - Congress mandated that excess reserve be amortized using Average Rate Assumption Method (ARAM) over a period no shorter than the remaining life of the associated plant.

# Tax Reform Rate Reduction – Take 2

## Tax Reform Tax Cuts and Jobs Act (TCJA)

- Reduction in Federal Corporate Income Tax Rate from 35% to 21%
  - Regulatory income tax expense for ratemaking is reduced
- Excess Deferred Income Taxes (EDIT) amortized using
  - Average Rate Assumption Method (ARAM) or
  - Reverse South Georgia Method (RSGM)
    - if vintage book and tax records are not sufficiently maintained
- Flow Through prohibited

# Excess Accumulated Deferred Income Taxes (EADIT)

## Drivers Creating of EADIT

- Federal Income Tax Rate Reduced from 35% to 21%
- GAAP Requires Accumulated Deferred Income Taxes (ADIT) to be Recorded at Statutory Rate (21%)
- This creates Excess ADIT for deferred taxes recorded at 35% which will reverse at 21%.
- This Excess ADIT is reclassified to a Regulatory Liability *at the revenue requirement level.*

## Requirements for Protected vs Non-Protected

### Protected Excess ADIT

- **For what:** Property related with method life book-tax differences
- **Options:** Average Rate Assumption Method (ARAM) or Reverse South Georgia Method

### Non-Protected Excess ADIT relates to:

- **For what:** Property related book/tax temporary differences that are not related to method life (e.g., tax repairs)
- **For what:** Non property related book/tax timing differences like pension, payroll-related items, etc.
- **Options:** No normalization requirements, but companies should generally seek an amortization life which matches the underlying temporary difference.



# Comparison: Protected EADIT Amortization Methods



Method	Average Rate Assumption Method	Reverse South Georgia
Requirement	Reverses Excess ADIT when book depreciation exceeds tax depreciation on a vintage-by-vintage basis	Reverse Excess ADIT quantified at the time of the tax rate change ratably over the remaining regulatory asset life
Timing	Reversal takes place primarily in the later years of the asset lives, when tax depreciation runs out and book depreciation continues	Reversal takes place evenly from the date of the tax rate change, even though the temporary difference hasn't reversed in all cases
Pros/Cons	Allows utility to retain interest free loan from the IRS for a longer period, thus delaying debt and equity transactions to replace this zero cost capital	Simpler to compute, but refunds these amounts to ratepayers prematurely and in some cases prior to the reversal of the related temporary difference

# What if Future Tax Rates Increase – Take 3?

## For example, say the tax rate increases to 28%



- Income Tax expense will go up increasing revenue requirements for any federal tax rate increase.
- Similarly, ADIT will go up decreasing rate base and providing additional cost-free capital.
- The previously recorded Excess ADIT would be recalculated and a new ARAM/RSG method would be required.
- Treatment of the deficient ADIT will be treated on a case-by-case basis for each utility commission.
- Additional rates may be required to “recapture” excess EDIT amortization.



# Bonus Depreciation



# Bonus Depreciation

- “Bonus” depreciation allowed the designated percentage of the qualifying asset cost to be immediately deducted
- The cost of the asset in excess of the bonus deduction is depreciated using normal IRS depreciation rates
  - Normal rates are based on MACRS or modified accelerated cost recovery system enacted in 1986
- Bonus depreciation drove significant tax deductions for Utilities through 2018 and helped drive Net Operating Losses.
- The Tax Cuts and Jobs Act effectively discontinued Bonus Depreciation for Utilities.

Bonus Depreciation		
Start Date	End Date	Bonus
9/11/2001	5/5/2003	30%
5/6/2003	12/31/2004	50%
1/1/2008	9/8/2010	50%
9/9/2010	12/31/2011	100%
1/1/2012	12/31/2017	50%
1/1/2018	12/31/2018	0%
1/1/2019	12/31/2019	0%

# Bonus Depreciation – NOL Carry Forward

- Bonus Depreciation may create a Net Operating Loss
  - The extra depreciation may wipe out all of the taxable income and create a net operating loss
  - For C-Corporations, the net operating loss can be carried back two years and/or carried forward for up to 20 years
  - For S-Corporations and Partnerships, the net operating loss is passed through to the individual owners – can be carried back 2 years or carried forward 20 years
  - The Tax Cuts and Jobs Act changed the carryback and carryforward rules to after 1/1/2018 NOL's can only be carried forward indefinitely.
- Must Normalize the Net Operating Loss related to Bonus Depreciation
  - Creates a Deferred Tax Asset that Offsets the Deferred Tax Liability created by the Bonus Depreciation
  - Accumulated Deferred Tax may only reflect the amount of tax savings that were actually able to take as part of cash payment

## Simplified Example – NOL Carry Forward

Investment= \$1,100      Book Life=30 years 100% Bonus Depreciation

	<u>Book</u>	<u>Tax</u>	<u>Difference</u>
Income (before Dep. & Tax)	\$1,000	\$1,000	\$ 0
Depreciation	<u>37</u>	<u>1,100</u>	<u>(1,063)</u>
Taxable Income	\$ 963	(\$ 100)	(\$1,063)
Tax Rate	<u>21%</u>	<u>21%</u>	<u>21%</u>
Tax Expense	\$ 202	(\$ 21)	(\$ 223)

Net Deferred Tax

Portion of Bonus Depreciation  
Unable to Use in Current Year

# Simplified Example – NOL Carry Forward



## Deferred Tax Liability

Book Depreciation	\$ 37
Tax Depreciation	<u>(\$1,100)</u>
Difference	(\$1,063)
Tax Rate	<u>21%</u>
Deferred Tax Liability	(\$ 223)

## Deferred Tax Asset

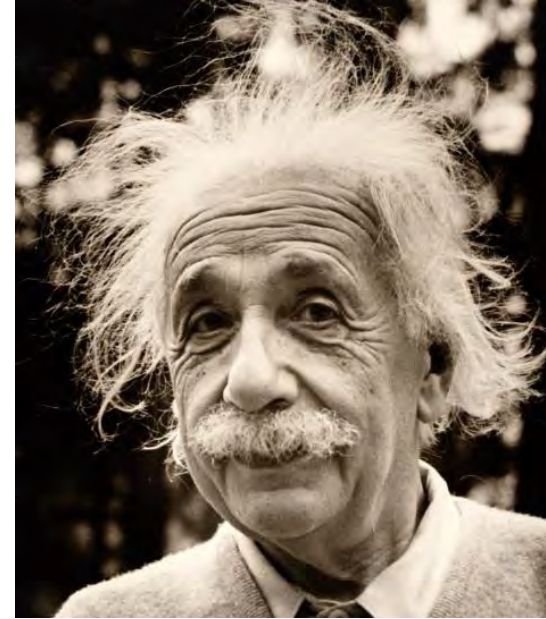
Taxable Income (NOL)	(\$ 100)
Tax Rate	<u>21%</u>
Deferred Tax Asset	\$ 21

The net of the Deferred Tax Liability (\$223) and Deferred Tax Asset \$21 Equals the Amount of Tax Expense Computed for Ratemaking (\$202)

## Poll Question

Normalization require Net Operating Losses to be...

1. Recognized as a reduction to rate base
2. Recognized as an increase to rate base
3. Given to rate payers
4. Ignored

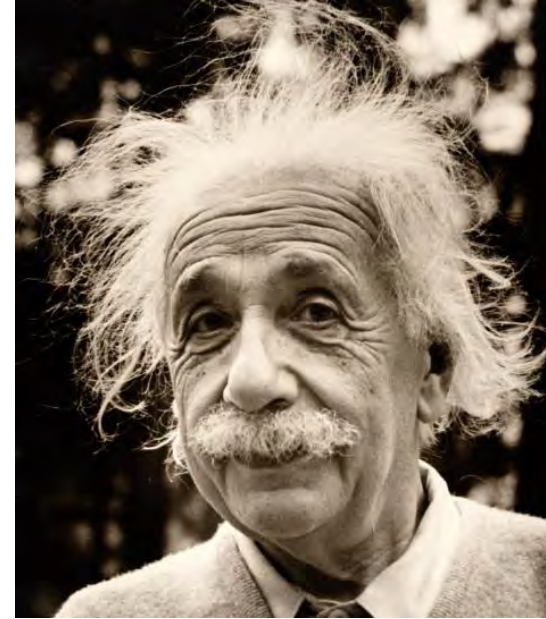




## Poll Question

Normalization require Net Operating Losses to be...

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# Inflation Reduction Act of 2022



# Wind and Solar Investment Tax Credits (ITC)



- Under past programs **wind credits** were generally taken as PTC's and **solar credits** were ITC's. These credits were phasing-out prior to the Inflation Reduction Act (IRA).
  
- Under the IRA, ITC were extended and available for projects placed in service January 1, 2022, to December 31, 2025.
  - Base Credit as a % of Cost 6%
  - Total credit if prevailing wage and apprenticeship requirements are met. 30%
  
- \* Bonus amounts (as a percentage of the credit amount of 10% to 20%) are also available where domestic content requirements are met or when the facilities are constructed in certain energy communities or low-income communities.

# Production Tax Credits (PTC)

- A federal tax credit for renewable electricity production. The credit is expressed as a per/kWh amount for projects placed in service January 1, 2022, to December 31, 2025:

- Base credit 0.3 cents/kWh
- Total credit if prevailing wage and apprenticeship requirements are met. 1.5 cents/kWh

\* Similar to the ITC, there are also bonus PTC available (as a percent of the PTC from 10% to 20%) where domestic content requirements are met, or facilities are constructed in an energy or low-income community.

# New Technology Neutral Clean Electricity PTC and ITC

- Effective beginning 2025 phasing down to later of 2032 or when emissions criteria are met, that is when the electric power sector emits 75% less carbon than 2022 levels.
- Same rates as ITC and PTC described in previous slides for projects that generate electricity and yield zero greenhouse gas emissions.



# New Credit Clean Hydrogen PTC

- 10-year incentive for clean hydrogen production. One of the core tax credits provided in the IRA.
  - Base credit \$0.60 cents/kg H<sub>2</sub>
  - Total credit if prevailing wage and apprenticeship requirements are met. \$3.00 cents/kg H<sub>2</sub>
- Also contains emission thresholds.
- Credit is very large in relation to project costs ranging from an estimated 50% to 90%.
- Adders for powering of hydrogen production facility for green hydrogen by wind or solar.
- Project must begin construction by 2033.

# New Investment Tax Credits – Energy Storage



- New under Inflation Reduction Act. ITC is based on energy storage system (ESS) projects, can be co-located with solar or standalone.
  - Base Credit as a % of Cost 6%
  - Total credit if prevailing wage and apprenticeship requirements are met. 30%
- Construction must begin before 2025.
- Minimum capacity of 5 kWh
- Establishes max 30% ITC through 2032,
  - Reducing to 26% in 2033 and 22% in 2034.

# New Tax Credits – Nuclear



- New under Inflation Reduction Act
- Can take either the PTC or ITC
- PTC is 2.5 cents per kWh and 10% adder for facility built in an energy community
- Construction must begin before 2025
- Base credit is 30% and up to 40% for facility built in an energy community



# Other Considerations of Inflation Reduction Act

- Qualified ITC and PTC owners can transfer amounts to a third party
- Non-taxable entities can receive payments in lieu of tax credits
- For certain credits you have option of ITC or PTC. Opting for PTC essentially bypasses normalization rules
- Discussion point – how are your utilities responding to the Inflation Reduction Act?
  - ITC or PTC?
  - Any consideration or discussion of transfer of amounts?
  - Have regulators weighted in on treatment of transfer of ITC to third party?
- To offset costs of Inflation Reduction Act a 15% AMT will be assessed on corporations with average adjusted financial statement income of \$1 billion or more over a 3-year period.

# Accounting Entries for ITC and PTC



## Initial Recording of ITC

Dr. 411.4 Investment Tax Credit Adjustments

Dr. 190 ADIT – ITC

Cr. 255 Investment Tax Credit

Cr. 254 Regulatory Liability

Dr. 236 Income Taxes Payable

Cr. 409.1 Current Tax Expense

## Amortization of ITC

Dr. 255 Investment Tax Credit

Dr. 254 Regulatory Liability

Cr. 190 ADIT – ITC

Cr. 411.4 Investment Tax Credit Adjustments

Amortization of ITC must be no more rapid than the book life of the underlying assets.

Note that the IRA requires a 50% basis reduction for ITC which is not shown in the above calculation. This difference is similar to AFUDC Equity.

# Accounting Entries for PTC

Periodic Recording of PTC

Dr. Current Taxes Payable

Cr. Production Tax Credit

Note that PTC is not subject to the normalization rules.

# Rate Making for ITC

Revenue Act of 1971 restricted the flowthrough of the Investment Tax Credit by Utility Commissions – 26 CFR 1.46-6

- Regulated utilities choose between two ratemaking methods:

## Option 1

- Reduction from **rate base** – to be restored no less ratably than over the life of the asset

## Option 2

- Amortized into **operating income** no more rapidly than ratably over the life of the asset.
- Note that normalization violations associated with ITCs could result in the recapture of the greater of
  - (1) all ITCs previously claimed in open years or
  - (2) the unamortized ITC balance as of the violation date.



# IRS Developments and Trends



# Tax Reform

## Final Tax Reform Tax Cuts and Jobs Act (TCJA)

- Only NOL's generated after 1/1/2018 can be carried forward indefinitely. Only 80% of the NOL can be used in any given year. NOL's create deferred tax debits which generally increase rate base.
- There have been several Private Letter Rulings related to these deferred tax debits which have recently indicated the portion of these NOL's related to accelerated depreciation should be considered a rate base item.

# EADIT on Property which Ceases to be Public Utility Property

## Increased Prevalence because of early retirements of coal plants

- 2008 IRS Regulations specified that the EADIT related to property which is no longer public utility property can be returned to customers in the same manner as if the property had remained public utility property.
- Exceptions to this are “normal retirements”
- EADIT can also be transferred to an acquiring utility as an election

### Observation –

- Set it and forget it. Requires a calculation given remaining book lives prior to retirement. May require calculating a runout of book and tax depreciation depending on method elected.

# IRS Developments



## **Rev. Proc. 2020-39 August 2020**

Issued in August 2020 and clarified the circumstances under which ARAM or the Alternate Method (RSGM) can be used.

Requires ADIT related to property related Net Operating Losses be considered protected.

## **PLR 202033002 August 2020**

Private Letter Ruling held that Cost of Removal is not a protected item under the IRS normalization rules. Many utilities have historically combined this item with method/life temporary differences and treated the overall difference as protected.

Several additional PLRs have been issued consistently holding that Cost of Removal is not protected.



# IRS Developments



## **PLR 101961-21**

Issued in July 2021 held that an excess income tax “tracker” that returned to rate payers the change in the excess deferred tax outside of a rate case was a violation of normalization rules. The letter found the tracker failed to recognize similar adjustments to rate base, ADIT, book depreciation expense, and tax expense as required by IRC §167.

## **General Point on IRS Tax Lives**

Wind and solar MACRS lives are 5 years versus 15 – 20 on normal public utility property. Accelerated tax deductions and large ADIT build-up for renewable projects. Could create NOL position.

# IRS Developments



## **PLR 202426002**

Issued in March 2024 held that an utility B which is part of Parent Company A filed consolidated income tax returns. Utility B and had Federal income tax NOLs which created an ADIT asset on the utility B's books and was compensated by the parent under the Tax Allocation Agreement. For GAAP reporting Utility B recorded the cash received as a reduction of the ADIT asset. Utility B then performs a ratemaking adjustment for regulatory purposes to re-establish the ADIT asset as an addition to rate base.

The State Commissions argued that the ADIT asset should not be recognized in rate base as Utility B has been paid in cash for the NOL through the Tax Allocation Agreement.

The IRS held that reducing the ADIT asset by the Tax Allocation Agreement payments to Utility B would violate the IRS normalization rules.



# FERC Developments



# FERC Developments

## Order 864 and 864-A

### Electric Transmission Formula Rates –

Formula Rates must contain a means by which to refund Excess ADIT and the related amortization must be built into the formula rates.

- Excess ADIT must reduce rate base.
- Amortization of Excess ADIT must reduce revenue requirements
- A new ADIT worksheet is required in Formula Rate Filings to track Excess ADIT activity

### Electric Transmission Stated Rates –

- Companies with a previously approved Excess ADIT amortization methodology are required to immediately begin amortizing Excess ADIT.
- Companies without a previously approved Excess ADIT amortization methodology are required to develop a method and immediately begin amortizing Excess ADIT and the method is subject to FERC review in next rate case

Protected and unprotected excess ADIT must have reasonable amortization periods.

# FERC Order 898

## Summary

*On June 29, 2024 FERC issued Order 898 in which the Unified System of Accounts (USOA) was updated. Changes include:*

- (1) specific accounts for renewable assets*
- (2) accounts for gain/loss on renewable energy credits (RECs)*
- (3) specific accounts for computer hardware, software, and communication equipment*

## PowerPlan Reading

- Effective prospectively on 1/1/2025
  - Applies to balances as of point-in-time (2025) without need for prior year historical restatements
- FERC accounts added for renewable assets (Solar, Wind, Other Renewable, Energy Storage)
- FERC accounts added for gain/loss on RECs (411.11 & 411.12)
- Distinct accounts added to segregate **software, hardware, and comm equipment** costs across **all** functional groups
  - Further, "... if utilities cannot readily identify [computer software, hardware, and communication equipment] functional level of detailed balances of plant with associated accumulated depreciation, such balances may reside in the accounts initially used by the utilities."

# FERC Order 898

## Key questions for you

- Have you considered impacts of this FERC Order to your business?
  - Conversion considerations
  - Tax impacts (tax assets, depreciation group effects, etc....)
    - Greater ability to functionalize ADIT based on specific assets
    - Greater ability to functionalize tax expense calculations
- Are the changes to renewable energy asset accounting and computer/communication equipment costs equally significant to you?
- Do you believe you will be performing transfers of computer costs on historical assets? Or do you expect to retain historical costs in their current accounts?

# FERC Developments

## AI-24 Accounting for the Transferability of Income Tax Credits

**Released September 12, 2024**

Comments are being requested.

### **Seller:**

The Accounting Release would require the selling entity to treat the transfer of ITC as a nonoperating activity including the revenue received and costs to facilitate the transfer.

Derecognition upon selling all balances of ITC previously recorded including related ADIT.

### **Buyer:**

Buyer would record the ITC or other tax credit in the same accounts as if it had itself generated the tax credit. Any costs incurred to facilitate the purchase should be recorded as non-operating. ITC acquired would be treated as flow-through or deferral method consistent with the buyer's existing accounting regulations.

### **Overall:**

This treatment for accounting is not intended to prejudice the ratemaking treatment.



# Repair Deduction





# History

- What's a repair?
  - Has the property repaired been adapted to a new or different use?
  - Has the useful life of underlying property been appreciably prolonged?
  - Has there been a material increase in value to underlying unit of property?

# Tax Repairs: Timeline

## Brief History of IRS Tangible Property Capitalization Regulations:

- **2008:** Proposed Regulations issued
  - No ‘Safe Harbor’ or Unit of Property definitions
  
- **2011:** “Safe Harbor” and Unit of Property rules defined:
  - **Telecom Wireless & Wireline Assets** - Revenue Procedure 2011-27, 28
  - **Electric T&D Network Assets** - Revenue Procedure 2011-43
  - December: **Temporary Regulations** issued
  
- **2013:**
  - **Generation Assets** - Revenue Procedure 2013-24
  
- **2024:**
  - Revenue Procedure for Natural Gas 2024-15



# Key Terms

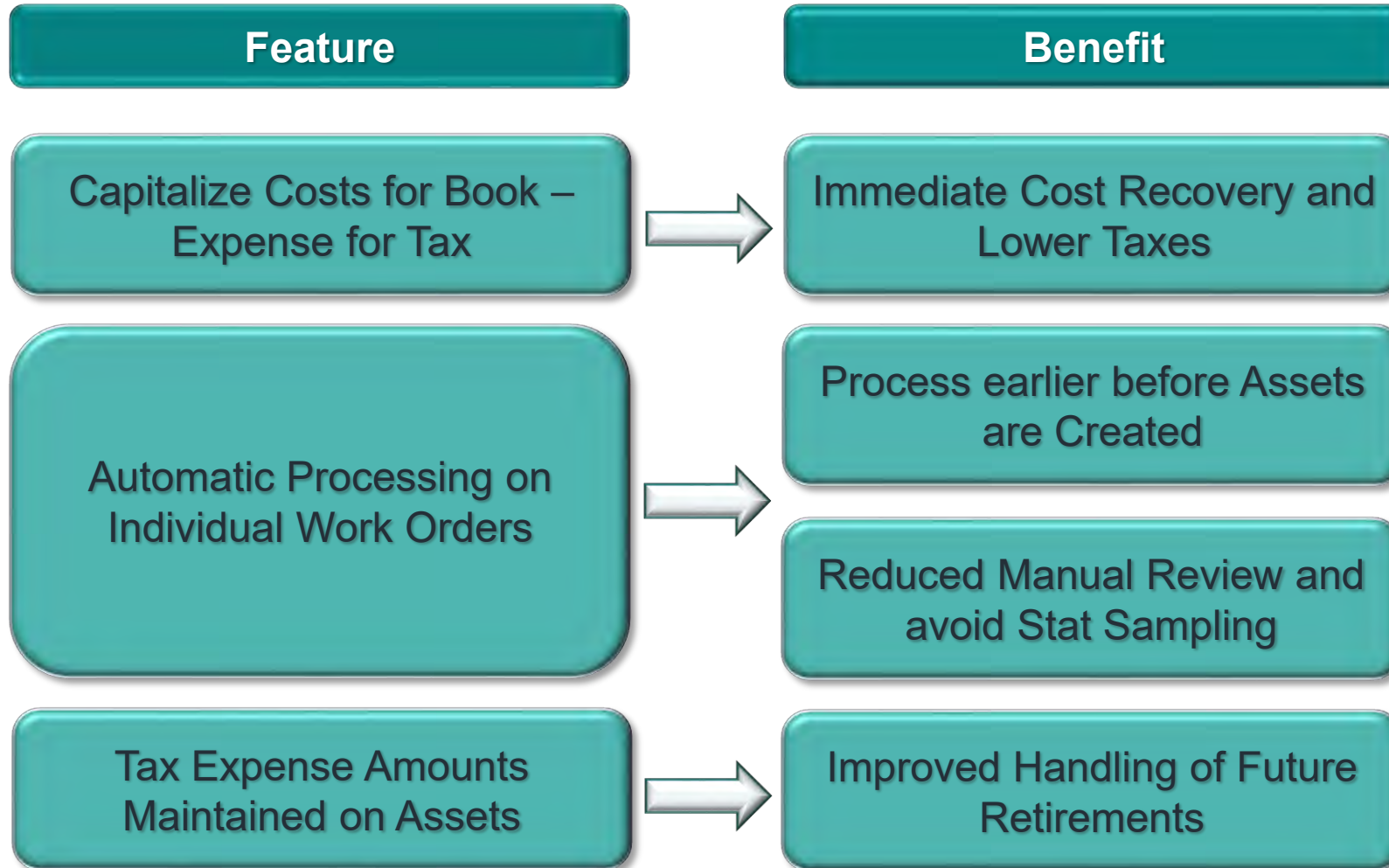
- **Unit of Property**

IRS Rev Proc 2011-43 provided guidance for electric utilities, and other IRS Revenue Procedures since then have clarified this for other industries. In Tax Repairs, the Unit of Property, or UOP, is a fundamental factor in all tax expense calculations and all UOPs are defined in the Tax Repairs configuration during implementation.

# Gas Repairs Solution Matrix

Property Type	Tax Unit of Property	Repair Location	Aggregation Rules	Safe Harbor Method	Nuances
Distribution – Linear – Specific	<u>Major Component:</u> Mains <u>Minor Component:</u> Services <u>Includes:</u> Fittings, Valves, Tunnels, Casing, Cathodic Protection, Instrumentation & Controls, Connectors	Zip Code	Yes	4-mile Threshold	<ul style="list-style-type: none"> <li>Subject to 5% increase capacity test, with certain “outs” if related to safety</li> <li>Additional calculation defined for unidentified service property</li> <li>Can aggregation by zip code be ignored if entire authorizing document is under 4 miles?</li> </ul>
Distribution – Linear – Blanket	<u>Major Component:</u> Mains <u>Minor Component:</u> Services <u>Includes:</u> Fittings, Valves, Tunnels, Casing, Cathodic Protection, Instrumentation & Controls, Connectors	Not Applicable	N/A	50k De-minimis Rule “Reasonable” Allocation Method	<ul style="list-style-type: none"> <li>If Zip Code is available by “event” and don’t have a 50k policy, blankets may really need to be handled like a specific project under the WMIS method</li> </ul>
Transmission – Linear – Specific	<u>Major Component:</u> Transmission Pipe <u>Includes:</u> Fittings, Valves, Tunnels, Casing, Cathodic Protection, Instrumentation & Controls, Connectors	Hydraulic Subsystem	Yes	10% by Hydraulic Subzone	<ul style="list-style-type: none"> <li>Subject to 5% increase capacity test, with certain “outs” if related to safety</li> </ul>
Transmission – Linear – Blanket	<u>Major Component:</u> Transmission Pipe <u>Includes:</u> Fittings, Valves, Tunnels, Casing, Cathodic Protection, Instrumentation & Controls, Connectors	Not Applicable	N/A	50k De-minimis Rule “Reasonable” Allocation Method	<ul style="list-style-type: none"> <li>If Zip Code is available by “event” and don’t have a 50k policy, blankets may really need to be handled like a specific project under the WMIS method</li> </ul>
Non-Linear	Many (Examples: Compressor Station equipment and Storage Facility equipment like tanks, wells, scrubbers, etc.)	Station/ Storage Facility	No	Open to Interpretation	<ul style="list-style-type: none"> <li>UOP definitions</li> <li>Notable exclusions for things like smart pipeline inspection gauges and cleaning pipeline inspection gauges</li> </ul>

# Tax Repairs: Features and Benefits



# Capital vs Expense, that is the Question:

- Asset-intensive companies have long standing issues with the IRS:
  - When are asset maintenance/replacement costs considered:
    - Repairs? (Tax deductible)
    - Capital improvements? (Not tax deductible)
    - Driven by the contradiction between Property and Tax Departments
      - Property tends to Capitalize, Tax (concerning Repairs) looking to deduct or expense
      - Especially difficult for the non-accounting members to understand different treatment between book and tax
        - Engineers
        - Field Personnel
- Additional questions for the IRS:
  - What is a “unit of property”?
  - Vague and/or ambiguous criteria for capitalization:
    - Has the property been improved?
    - Has the property been adapted to a new and different use?
    - Has the useful life of the property been prolonged?



# Why is this important?

- Capital expenditures are deducted over the tax life of the asset, typically 20 or 15 year MACRS. IRC Section 263(a)
- Repair and maintenance expenditures are current year deductions – IRC Section 162
  - “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...”
  - Deducting these costs in the current period versus over 20-year period provides cash flow benefits
  - Note that this is a timing difference and increases deferred tax liability (i.e., reduction to rate base)
- Repair Deductions are not subject to the Normalization Requirements so the tax benefits can be flowed through to customers by Commission

# Example of Income Tax Impact

## 21 Year Run-Out for First Year Impact

- Conclusion: \$916k / \$5M = about 18% impact

Year	Macrs 20 Tax Schedule	Tax Depreciation (Charged to Asset)	Tax Expense (Charged to Cost of Removal)	Current Year Additional Tax Expense	Tax Impact (40% Tax Rate)	Present Value of Tax Impact
Year 1	3.7500%	\$ 187,500	\$ 5,000,000	\$ 4,812,500	\$ 1,925,000	\$ 1,925,000
Year 2	7.2190%	\$ 360,950	\$ 0	-\$ 360,950	-\$ 144,380	-\$ 133,685
Year 3	6.6770%	\$ 333,850	\$ 0	-\$ 333,850	-\$ 133,540	-\$ 114,489
Year 4	6.1770%	\$ 308,850	\$ 0	-\$ 308,850	-\$ 123,540	-\$ 98,070
Year 5	5.7130%	\$ 285,650	\$ 0	-\$ 285,650	-\$ 114,260	-\$ 83,985
Year 6	5.2850%	\$ 264,250	\$ 0	-\$ 264,250	-\$ 105,700	-\$ 71,938
Year 7	4.8880%	\$ 244,400	\$ 0	-\$ 244,400	-\$ 97,760	-\$ 61,605
Year 8	4.5220%	\$ 226,100	\$ 0	-\$ 226,100	-\$ 90,440	-\$ 52,771
Year 9	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 48,214
Year 10	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 44,632
Year 11	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 41,335
Year 12	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 38,265
Year 13	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 35,438
Year 14	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 32,806
Year 15	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 30,383
Year 16	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 28,126
Year 17	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 26,048
Year 18	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 24,113
Year 19	4.4620%	\$ 223,100	\$ 0	-\$ 223,100	-\$ 89,240	-\$ 22,332
Year 20	4.4610%	\$ 223,050	\$ 0	-\$ 223,050	-\$ 89,220	-\$ 20,673
Year 21	2.2310%	\$ 111,550	\$ 0	-\$ 111,550	-\$ 44,620	-\$ 9,573
<b>Total</b>	<b>100%</b>	<b>\$ 5,000,000</b>	<b>\$ 5,000,000</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 916,091</b>

## Assumptions:

- \$5M Gets Expensed rather than charged in addition
- MACRS 20 Schedule
- 40% Effective Tax Rate (State & Federal)
- 8% Discount Rate for Present Value



# Example of Income Tax Impact

## Cumulative Effect

Year	Current Year Additional Tax Expense	Tax Impact (40% Tax Rate)	Present Value of Tax Impact
Year 1	\$ 4,812,500	\$ 1,925,000	\$ 1,925,000
Year 2	\$ 4,451,550	\$ 1,780,620	\$ 1,648,722
Year 3	\$ 4,117,700	\$ 1,647,080	\$ 1,412,106
Year 4	\$ 3,808,850	\$ 1,523,540	\$ 1,209,435
Year 5	\$ 3,523,200	\$ 1,409,280	\$ 1,035,863
Year 6	\$ 3,258,950	\$ 1,303,580	\$ 887,195
Year 7	\$ 3,014,550	\$ 1,205,820	\$ 759,871
Year 8	\$ 2,788,450	\$ 1,115,380	\$ 650,814
Year 9	\$ 2,565,350	\$ 1,026,140	\$ 554,392
Year 10	\$ 2,342,300	\$ 936,920	\$ 468,693
Year 11	\$ 2,119,200	\$ 847,680	\$ 392,640
Year 12	\$ 1,896,150	\$ 758,460	\$ 325,290
Year 13	\$ 1,673,050	\$ 669,220	\$ 265,756
Year 14	\$ 1,450,000	\$ 580,000	\$ 213,265
Year 15	\$ 1,226,900	\$ 490,760	\$ 167,085
Year 16	\$ 1,003,850	\$ 401,540	\$ 126,582
Year 17	\$ 780,750	\$ 312,300	\$ 91,157
Year 18	\$ 557,700	\$ 223,080	\$ 60,292
Year 19	\$ 334,600	\$ 133,840	\$ 33,493
Year 20	\$ 111,550	\$ 44,620	\$ 10,558
<b>Total</b>		<b>\$ 18,334,860</b>	<b>\$ 12,237,990</b>

## Assumptions:

- \$5M Annually for 20 Years
- MACRS 20 Schedule
- In Year 2 the total benefit is Year 2 for the first year and Year 1 benefit for the second year and so on...



**With Clarity Comes Confidence.**





**Questions ?**

