[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 3165 AND H.R. 6806

RELATING TO

ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 15, 1980

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INTRODUCTION

This pamphlet was prepared by the staff of the Joint Committee on Taxation for the Committee on Ways and Means hearing scheduled for April 15, 1980, on legislative proposals relating to the tax consequences of the accounting treatment of the investment tax credit and accelerated depreciation for public utility ratemaking purposes.

The first part of the pamphlet is a summary of present law and two specific legislative proposals before the Committee—H.R. 6806 (introduced by Messrs. Corman and Rousselot) and H.R. 3165 (introduced by Mr. Stark). This is followed by a discussion of the background and legislative history of accelerated depreciation and the investment tax credit—particularly as they relate to public utilities. The third part of the pamphlet is a description of present law and the two bills.

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I. SUMMARY

A. Present Law

With certain exceptions for companies which are grandfathered, public utilities are eligible to use the investment credit and accelerated depreciation for tax purposes only if the tax benefits from accelerated depreciation and the investment credit (or, in some cases, a portion of the credit) are normalized for ratemaking purposes. Normalization generally requires that the tax benefits be taken into account for rate-making purposes no more rapidly than ratably over the lives of the assets with respect to which the benefits are claimed. The normalization rules for accelerated depreciation allow the full benefit to be flowed through to customers ratably over the period of tax deferral; the rules for the investment credit require a sharing of the tax benefit between the consumers and the shareholders of the utility. The normalization rules relating to accelerated depreciation were imposed in 1969, and the normalization rules relating to the investment credit, for the most part, were imposed in 1971 and 1975.

B. Summary of Bills

1. H.R. 6806—Messrs. Corman and Rousselot

Transitional Rules and Revisions in the Normalization Requirements for Public Utility Property Eligible for the Investment Tax Credit and Accelerated Depreciation

The bill would provide that violations of the normalization requirements of present law (and of the bill) would not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if such violations involved the use of projections or adjustments (1) that applied for any period ending prior to March 1, 1980, and (2) that were included in an order entered by a State or local public service or public utility commission prior to January 1, 1980.

The bill would restate and make more specific the present normalization rules relating to accelerated depreciation and the investment credit. It would also give the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking adjustments are inconsistent with normalization. The amendments to the normalization rules generally would apply to taxable years beginning after December 31, 1979.

2. H.R. 3165—Mr. Stark

Limitations of the Flow Through of the Investment Tax Credit in the Case of Certain Regulated Utilities

The bill would amend the investment credit normalization rules to provide that the investment credit would be allowed as long as regulatory commissions require that it be flowed through to customers no faster than would occur (a) if the rate base is reduced by the amount of the credit and (b) if a *pro rata* portion of the credit is flowed through to customers each year over the life of the assets. Thus, a regulatory commission would be allowed to make both the adjustment permitted under the present ratable flow-through method *and* that permitted under the present rate base reduction method, rather than having to choose one or the other as under present law.

The bill would apply with respect to qualified investment for taxable years beginning after the date of enactment.

II. BACKGROUND

Generally, utility regulatory commissions allow a utility to charge customers an amount equal to the utility's cost of service. The cost of service includes the annual operating expenses of the utility, such as labor and fuel, and also the capital expense allocable to that year. The capital expense which can be passed through as higher prices to customers consists of an annual depreciation charge and also a rate of return on the utility's rate base (the basis of its assets). When the price of an asset purchased by the utility declines, two adjustments would have to be made to the cost of service. First, the annual depreciation expense would be reduced over the life of the asset. Second, the utility's rate base would be reduced along with the component of the cost of service representing the rate of return on that base.

Accelerated depreciation methods and the investment credit were enacted in order to encourage higher rates of investment in new and replacement equipment. This result is achieved by increasing the estimated rate of return after taxes over the life of the asset involved through reducing the initial cost of the investment or making possible a more rapid recovery of the funds invested in capital assets.

A. Accelerated Depreciation

In general

Accelerated rates of depreciation, i.e., rates of depreciation that are faster than straight-line, or ratable depreciation, over the useful life of an asset were enacted in the Revenue Act of 1954. Congress made this form of depreciation available because it believed that accelerated depreciation would stimulate a higher investment in new equipment and processes.

Subsequent congressional action with respect to depreciation generally has involved approval of a method to reduce the useful lives of assets so that depreciation may be calculated over a shorter period (such as the ADR system—Asset Depreciation Range—adopted in 1971 and various special 5-year amortization provisions). This is a different form of accelerated depreciation, but it tends to produce the same effect as a faster rate of depreciation in the calculations of a potential investor.

Accelerated depreciation for public utilities

When it considered the Tax Reform Act of 1969, Congress found that public utility regulatory agencies were adopting very different methods of flowing through to customers the tax benefit from accelerated depreciation. About half the regulatory agencies required utilities that used accelerated depreciation to flow through the tax reduction from accelerated depreciation immediately as lower prices. Some agencies insisted that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, treated the utilities as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have used straight-line depreciation on their tax returns. Other agencies permitted the utilities under their jurisdiction to normalize the deferred tax liabilities resulting from accelerated depreciation (i.e., pass through the tax benefits to customers ratably over the useful life of the asset). The trend, however, appeared to be towards more and more use of immediate flow-through. As a result, Congress decided, as part of the Tax Reform Act of 1969, essentially to freeze the then current situation with regard to the depreciation method which could be used by a regulated public utility.

The freeze applied to existing property as of August 1, 1960. It permitted current practices to continue, but provided that subsequent changes to a faster rate of flow-through mandated by a regulatory agency would mean that the taxpayer would be denied the right to accelerated depreciation for tax purposes and would be required to use straight-line depreciation.

For new (i.e., post 1969) property, a public utility generally would be allowed to flow through the tax benefits from accelerated depreciation where that was the practice as of August 1, 1969. In all other cases, straight-line depreciation would be required, unless the tax benefits from accelerated depreciation were normalized.

B. Investment Tax Credit

In general

The investment tax credit (generally, at 7 percent, except as noted below for public utilities) was enacted initially in the Revenue Act of 1962. In 1964, Congress repealed a provision in the 1962 Act which required that the basis for depreciation of eligible property be reduced by the amount of the credit. In 1966, the credit was suspended during an investment boom, and the credit was restored in 1967 when the rate of investment growth subsided.

The investment credit was repealed as of April 18, 1969, in the Tax Reform Act of 1969, but was reenacted in the Revenue Act of 1971. In 1975, the investment credit was increased to 10 percent temporarily, and the 10-percent credit rate was made permanent in the Revenue Act of 1978.

The Energy Tax Act of 1978 enacted a 10-percent energy investment tax credit for various kinds of energy-related property. This credit was expanded, and increased to 15 percent in certain cases, in the Crude Oil Windfall Profit Tax Act of 1980.

Investment tax credit for public utilities

Congress initially made a partial investment credit (3 percent instead of 7 percent) available to regulated public utilities. The reduced rate was a compromise between those who argued that utilities should be treated like other industries and those who argued that because regulated public utilities were guaranteed a satisfactory rate of return, they did not need Federal tax incentives to encourage capital investment.

In the Revenue Act of 1964, Congress provided that no Federal regulatory agency could flow through the tax saving from the investment credit to customers more rapidly than ratably over the useful life of the property. In addition, no Federal regulatory agency could require flow-through of any part of the credit in the case of any other property of a regulated company. Ratable flow-through was permitted in each of these situations, if the company consented.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services. (The 1971 Act also reduced the credit allowable to unregulated taxpayers to 4 percent for certain property used in competition with public utility property.)

When Congress restored the investment credit in 1971, it provided that the investment credit would not be available in cases where the regulatory agency required flowthrough of the credit at a faster rate than is provided in one of the normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. In the 1975 Act, the limit on the amount of tax liability offset by investment credits also was increased temporarily for public utilities because low earnings and tax liabilities were leaving utilities with large amounts of unused credits to carryforward.) When the investment credit for public utility property was increased to 10 percent in 1975, it was provided that flow-through could not be utilized by these grandfathered utilities with respect to the additional 6 percent. This rule was retained when the 10-percent rate was made permanent in 1978.

Public utility property is not eligible for the energy investment credit except for small-scale hydroelectric property, equipment used to produce oil shale or gas from geopressured brine, and "specially defined" energy conserving property.

III. PRESENT LAW AND DESCRIPTION OF BILLS

A. Present Law

Accelerated depreciation

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a reduction in cost of service and therefore flowed it through to customers currently as lower rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no investment incentive.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), a utility which had not previously used accelerated depreciation for Federal tax purposes could thereafter use accelerated depreciation only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[1]

Code section 167(l)(3)(G) provides that:

> "In order to use a normalization method of accounting with respect to any public utility property—
>
> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
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> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it

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[1] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply means the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;

(2) Gas or steam through a local distribution system;

(3) Telephone services;

(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or

(5) Transportation of gas or steam by pipeline, if the rates, for the furnishing or sale, are established or approved by certain regulatory bodies.

used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)-1(h)) interpret this section as defining normalization to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service. The Treasury Regulations (§ 1.167(a)-11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the tax savings from accelerated depreciation being reflected in the rates charged to customers ratably over the life of the asset being depreciated.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: First, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury and, second, to avoid the additional loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce utility profits.

Investment tax credit

In general, present law (Code sec. 46(f)) denies the investment tax credit (both the regular credit and any allowable energy credits) with respect to public utility property if a public utility regulatory commission requires that the benefit of the credit be flowed through to customers as lower prices in a manner which results in a more rapid flow-through than permitted by the Code.

Under certain exceptions, however, the benefits of the investment tax credit may be flowed through immediately to customers if an election is made and if the taxpayer was on a flow-through method of accounting for depreciation purposes prior to 1969. This immediate flow through applies only to the first 4 percent of the investment credit; the additional 6 percent for public utility property (i.e., the increase first provided to such property in 1975) must be accounted for under a normalization method of accounting (Code sec. 46(f) (3) and (8)). Special rules are also provided to prevent flow-through of the additional credit for contributions to an employee stock ownership plan (Code sec. 46(f)(9)).

Except for the special flow through rule in the preceding paragraph, the investment credit will be denied for public utility property if the regulatory commission's treatment of the credit results in benefits being flowed through to customers more rapidly than under either (a) the ratable flow-through method or (b) the rate base reduction method.

Under the ratable flow-through method, utilities pass through to customers a *pro rata* portion of the credit during each year of the useful life of the asset. The regulatory commission, however, may not require that the utility reduce its rate base by the amount of the credit. Therefore, even though the credit itself is flowed through to customers over the life of the asset, the utility's shareholders are allowed to earn a return on the 10 percent of the cost of the equipment which has, in effect, been supplied by the Federal Government through the investment credit.

Under the rate base reduction method, the utility's rate base is reduced by the amount of the credit, so that the shareholders are prevented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. However, under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

For long-lived assets, the rate base reduction method is more favorable to customers and less favorable to shareholders. For short-lived assets, the opposite is true.

The Code (sec. 46(f)(6)) currently provides that for purposes of determining ratable restorations to basic under the rate base reduction method or ratable portions under the ratable flow-through method, the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Thus, the investment credit must be flowed through ratably under either method over a period that is the same as is used in computing depreciation expense in the taxpayer's regulated books of account.

B. DESCRIPTION OF BILLS

1. H.R. 6806—Messrs. Corman and Rousselot

Transitional Rules and Revisions in the Normalization Requirements for Public Utility Property Eligible for the Investment Tax Credit and Accelerated Depreciation

Issues

Considerable controversy has arisen over the proper application of these normalization rules, especially in California. Prior to 1969, the California Public Utility Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, Pacific Telephone and Telegraph Company and General Telephone Company, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation, and the Commission set rates as if accelerated depreciation had been elected and flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including 3 more decisions of the California Supreme Court), an order of the Commission became final which requires the telephone companies to use certain methods of passing through the investment credit and accelerated depreciation to their customers. Although no final determination has been made as to whether these methods comply with the Code's normalization requirements, the Internal Revenue Service has issued a private ruling which takes the position that the methods do not comply with such requirements. As a result, these telephone companies are potentially faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which cannot be flowed through by utilities which are otherwise grandfathered on a flow-through method.

The principal issues raised by the bill are (1) whether it is appropriate to provide a transitional rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used accounting methods which were prescribed by order of a State or local government public service or utility commission and (2) whether it is appropriate to make the normalization rules more specific in a manner generally based on current Treasury regulations.

One subsidiary issue raised by the bill is whether the complete forgiveness of tax in the transition rule is appropriate or whether some sort of "penalty" should be imposed. Another subsidiary issue is whether the cut-off date in the transitional rule is appropriate.

Explanation of the bill

In general

The bill contains two permanent amendments to the antiflowthrough rules which do not change the substance of present law as that law is interpreted by Treasury regulations. It also contains a transitional rule designed to benefit Pacific Telephone and Telegraph Company (a subcidiary of AT&T), General Telephone and Electronics, and Southern California Gas Company.

Accelerated depreciation

The bill generally would restate the present definition of normalization method of accounting (in Code sec. 167(l)(3)(G)) and would add language which generally follows the interpretation of this provision now contained in Treasury regulations.

These added provisions generally provide that normalization is not complied with if, for ratemaking purposes or for reflecting operating results in its regulated books of account, the taxpayer employs any adjustment that is inconsistent with (1) computation of its tax expense for ratemaking purposes as though straight-line depreciation were being used for tax purposes or (2) the reflection of the full amount of the deferred taxes in a reserve. The bill also would provide that an adjustment would be considered inconsistent with the normalization requirements:

> "if such adjustment is based on estimates or projections of the taxpayer's regulated tax expense, regulated depreciation expense, rate base used for ratemaking purposes, or the reserve [for deferred taxes], that are not consistent with observed relationships among such items, or if such adjustment otherwise is based on estimates or projections that do not employ consistent assumptions or bases for projection."

The bill would also give the Treasury Department authority to prescribe regulations defining other adjustments that are inconsistent with the requirements for normalization.

Investment tax credit

The bill would restate and add language to the provisions of the Code (sec. 46(f)(6)) which define the concept of "ratable" for purposes of flowing through the benefit of the investment tax credit or for making reductions in the rate base. The added language generally provides that, in determining ratable restorations to base under the rate base reduction method or ratable portions under the ratable flow through method—

> "the taxpayer's rate base, cost of service, or the [investment] credit . . . taken into account for ratemaking purposes is subject to any adjustment that results, directly or indirectly, in the rate base being restored less rapidly than ratably, or in the cost of service for ratemaking purposes being reduced by more than a ratable portion of the [investment] credit."

The bill would provide that an adjustment violates this new rule if it is based on estimates or projections of the amount by which the rate base is to be reduced, or of the amount of a ratable portion which may be flowed through, that are inconsistent with observed relationships between such amounts and the taxpayer's investment in property eligible for the investment credit, or if the adjustment is based on estimates or projections that do not employ consistent assumptions or bases for projection. In addition, the Treasury Department is given specific authority to prescribe regulations defining other adjustments that are inconsistent with the newly prescribed requirements.

Transitional rule

The bill would provide that violations of the normalization requirements of present law (and of the bill) would not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if such violations involved the use of projections or adjustments (1) that applied for any period ending prior to March 1, 1980, and (2) that were included in an order entered by a State or local public service or public utility commission prior to January 1, 1980.

Effective date

The provisions of the bill (other than the transitional rule) generally would apply to taxable years beginning after December 31, 1979. However, these provisions would be subject to modifications provided in the transitional rule.

Revenue effect

If the orders currently in effect by the California Public Utility Commission result in certain utilities doing business in California being eligible for accelerated depreciation and the investment tax credit, the bill would result in no revenue loss as long as orders in effect for periods after March 1, 1980, are in compliance with the revised normalization rules.

If these current orders do *not* comply with the current normalization rules in the Code, the bill would result in a revenue loss of approximately $1.85 billion attributable to accounting periods prior to March 1, 1980. This revenue loss generally would occur in the fiscal year or years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1981. The permanent changes would have no revenue effect.

2. H.R. 3165—Mr. Stark

Limitations of the Flow Through of the Investment Tax Credit in the Case of Certain Regulated Utilities

Issue

The issue is whether the rules relating to normalization of the investment credit for public utilities should be amended to permit both a reduction in the rate base by the amount of the credit and a flow through of a *pro rata* portion of the credit each year to customers over the life of the asset. Both of these adjustments would generally be allowed if there were a 10-percent reduction in the price of equipment, but present law requires a regulatory commission to choose one or the other for the investment credit.

Explanation of the bill

The bill would make the normalization of the investment credit similar to the normalization rules of accelerated depreciation under Code section 167(l); that is, it would allow the investment credit in cases where the regulatory commission required the full tax benefit from the credit to be flowed through ratably over the useful life of the asset. The investment credit would be treated as if it were capital supplied to the utility by the Federal Government at no cost to the utility.

The bill would amend Code section 46(f) to provide that the investment credit would be allowed as long as regulatory commissions require that it be flowed through to customers no faster than would occur (a) if the rate base is reduced by the amount of the credit and (b) if a *pro rata* portion of the credit is flowed through to consumers each year over the life of the asset.[2] Thus, the regulatory commission would be allowed to make both the adjustment permitted under the ratable flow-through method *and* that permitted under the rate base reduction method, rather than having to choose one or the other.

Effective date

The bill would apply with respect to qualified investment for taxable years beginning after the date of enactment.

Revenue effect

It is estimated that this bill would have no significant effect on budget receipts.

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[2] The bill also makes technical and conforming amendments and eliminates from the Code certain provisions relating to elections which would have to be made no later than June 1975.

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