Alert

January 10, 2018

Utility, Environmental & Energy Alert

News Concerning Recent Developments in Utility Law

COZEN O'CONNOR

Federal Tax Reform: Major Changes Impacting Public Utilities

On December 22, 2017, President Trump signed into law a comprehensive tax reform bill commonly known as the Tax Cuts and Jobs Act (the Act). The Act contains several changes of general applicability to the taxation of business enterprises, which also have significant implications for public utilities (utilities). Some of these changes were addressed in a previous Alert. This Alert focuses on the changes contained in the Act that are uniquely important to utilities. Except as otherwise indicated, the provisions summarized below are effective for tax years beginning after December 31, 2017.

Reducing Excess Deferred Tax Reserves

One of the Act's central features is that it cuts the corporate tax rate from a graduated system with a maximum rate of 35 percent to a flat rate of 21 percent. While a reduction in the corporate rate is generally good news for corporations, it results in accumulated excess deferred tax reserves that utilities are generally required to amortize in accordance with the average rate assumption method (ARAM). Utilities typically book large reserves to account for deferred taxes resulting from the excess of accelerated tax depreciation over straight-line depreciation used for regulatory purposes. The cut in the corporate tax rate generally creates excess reserves because previously recorded reserves assumed a 35 percent corporate tax rate, and a 21 percent rate produces less deferred taxes.

Under the Act, a normalization method of accounting is generally used for excess tax reserves associated with public utility property. To comply with normalization accounting method requirements for excess tax reserves, utilities are generally not permitted, in computing costs for rate-making purposes or recording operating results in their regulatory books, to reduce excess reserves more rapidly or greater than the reductions permitted by ARAM.

The Act provides for the use of ARAM for determining the timing of the return of the excess deferred taxes, but allows a utility that does not have the data necessary to compute ARAM to use a simplified alternative method of reducing excess deferred tax reserves, provided, as of the first day of the taxable year, which includes December 22, 2017, the utility (i) computes depreciation of public utility property on the basis of an average life or composite rate method and (ii) keeps underlying books and records that do not contain the vintage account data necessary to apply ARAM. ARAM requires amortization of the excess tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. The permitted alternative method computes the excess tax reserve on all public utility property based on the weighted average life or composite rate used to compute depreciation for regulatory purposes and reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For taxable years ending after December 31, 2017, a utility that violates normalization accounting method requirements by reducing excess reserves more rapidly than permitted by ARAM will be subject to an increase in taxes by such excess amount and will be limited to taking deductions for tax purposes equal to the depreciation used for regulatory purposes, which is commonly the straight-line method.

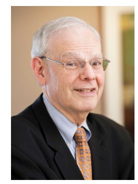
Repeal of Partial Immediate Expensing for Certain Public Utility Property

The Act repeals the allowance of partial immediate expensing of most types of public utility property, thereby reducing a significant source of tax deferral for utilities. Prior to the Act, utilities could deduct 50 percent of the adjusted tax basis of any qualified property as a depreciation expense in the first year such property was put into service. The Act repeals this allowance if such

Richard J. Silpe

Co-Chair, Tax

rsilpe@cozen.com
Phone: (215) 665-2704
Fax: (215) 665-2013



Ira G. Megdal

Senior Counsel

imegdal@cozen.com
Phone: (856) 910-5007
Fax: (877) 259-7984

David P. Zambito

Chair, Utility & Energy

dzambito@cozen.com
Phone: (717) 703-5892
Fax: (215) 989-4216

Related Practice Areas

- Tax
- Utility & Energy

property is primarily used in the trade or business of furnishing or selling electricity, water, gas, steam (through a local distribution system or by pipeline), or sewage removal services, if such business' rates are determined by any state or political subdivision, U.S. agency or instrumentality, public service or public utility commission, or the governing or rate-making body of an electric cooperative. This repeal applies to property acquired and placed into service after September 27, 2017.

Utilities covered by this provision can still use the Modified Accelerated Cost Recovery System (MACRS) to depreciate such property. However, because utilities typically have large capital investments, the repeal of first-year partial expensing could have a significant adverse impact on taxable income and cash flows.

While the Act repeals the allowance of partial immediate expensing for property held by certain types of utilities, it expands the allowed immediate expensing to 100 percent of the adjusted tax basis of qualified property for other businesses and expands the definition of qualified property to include used property acquired from a nonrelated taxpayer. Therefore, telecommunications utilities (and any other utility whose primary trade or business is not the furnishing or sale of electricity, water, gas, steam, or sewage removal) may immediately deduct 100 percent of the adjusted tax basis of qualified property placed into service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for certain property having a longer production period). Additionally, used property acquired by telecommunications utilities from an unrelated taxpayer in an actual or deemed asset acquisition may also qualify for the 100 percent, first-year depreciation deduction.

Contributions to Capital

Under current law, gross income of a corporation generally does not include any contribution to its capital. Under the Act, water and sewage disposal utilities can no longer exclude contributions in aid of construction from their gross income as contributions to capital. The Act also excludes from the meaning of "contribution to capital" any contribution by any government entity or civic group (other than a contribution made as a shareholder). Prior to the Act, corporations could exclude from gross income any property contributed by a government entity or civic group for the purpose of enabling such corporation to locate its business in a particular location. The Act repeals this exclusion.

The changes made by the Act with respect to contributions in aid of construction and contributions from government entities or civic groups generally apply to any contribution made after December 22, 2017. However, any contribution made by a government entity after December 22, 2017, pursuant to a master development plan approved prior to December 22, 2017, will still be excludable from gross income as a contribution to capital, provided such contribution otherwise meets the requirements for such exclusion.

Limitation on Business Interest Expense Deduction

The Act generally limits the deduction for net business interest expense for every business, regardless of its form, to 30 percent of adjusted taxable income. However, many types of utilities should be exempt from this limitation, because the Act excludes from the definition of business interest any interest paid or accrued on indebtedness properly allocable to an electricity, water, gas, steam, or sewage disposal business whose rates are determined by any state or political subdivision, U.S. agency or instrumentality, public service or public utility commission, or the governing or rate-making body of an electric cooperative. Accordingly, certain utilities will be exempt from the limitation imposed on the deduction of business interest. Telecommunications utilities, however, will not be exempt from this limitation.

If you would like to learn more about the issues discussed in this Alert, please contact the Energy, Environmental and Utility Practice Group or the Tax Group at Cozen O'Connor.