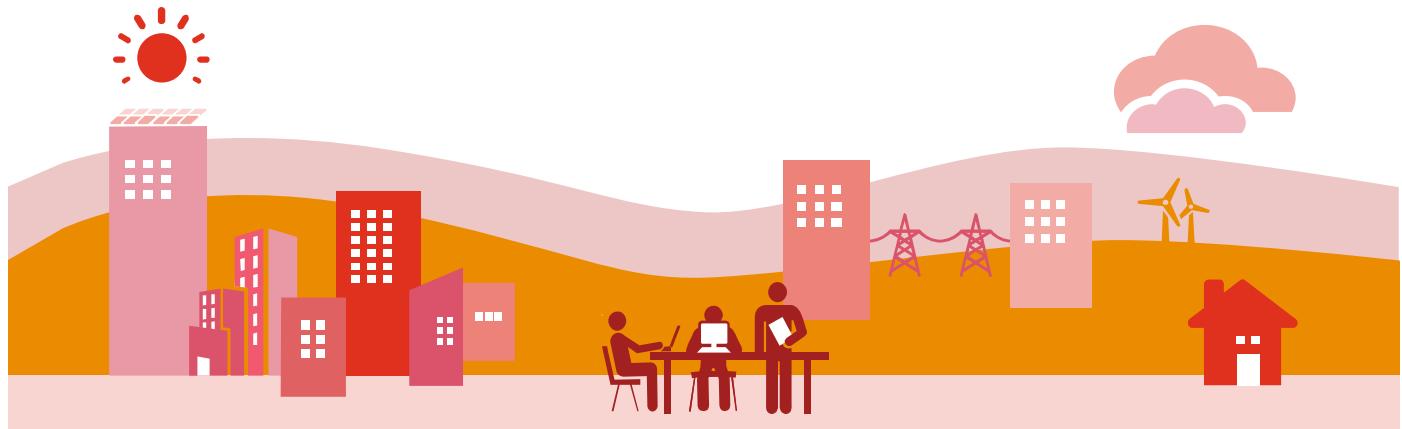


Tax Reform & Normalization Issues

NARUC Presentation

September 2017



Tax reform possibilities

Agenda

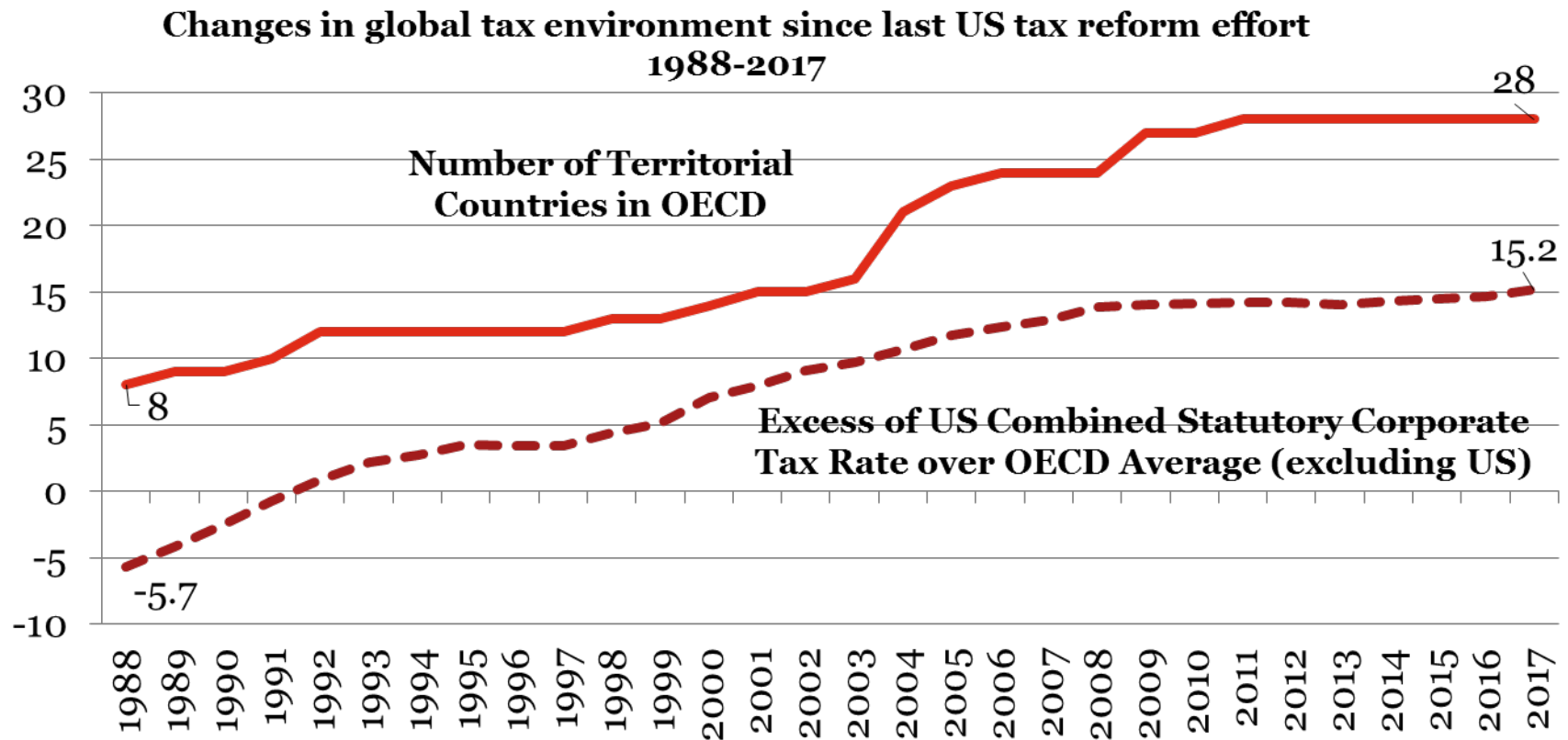
Tax reform update

Potential impacts to utilities

Normalization ruling update

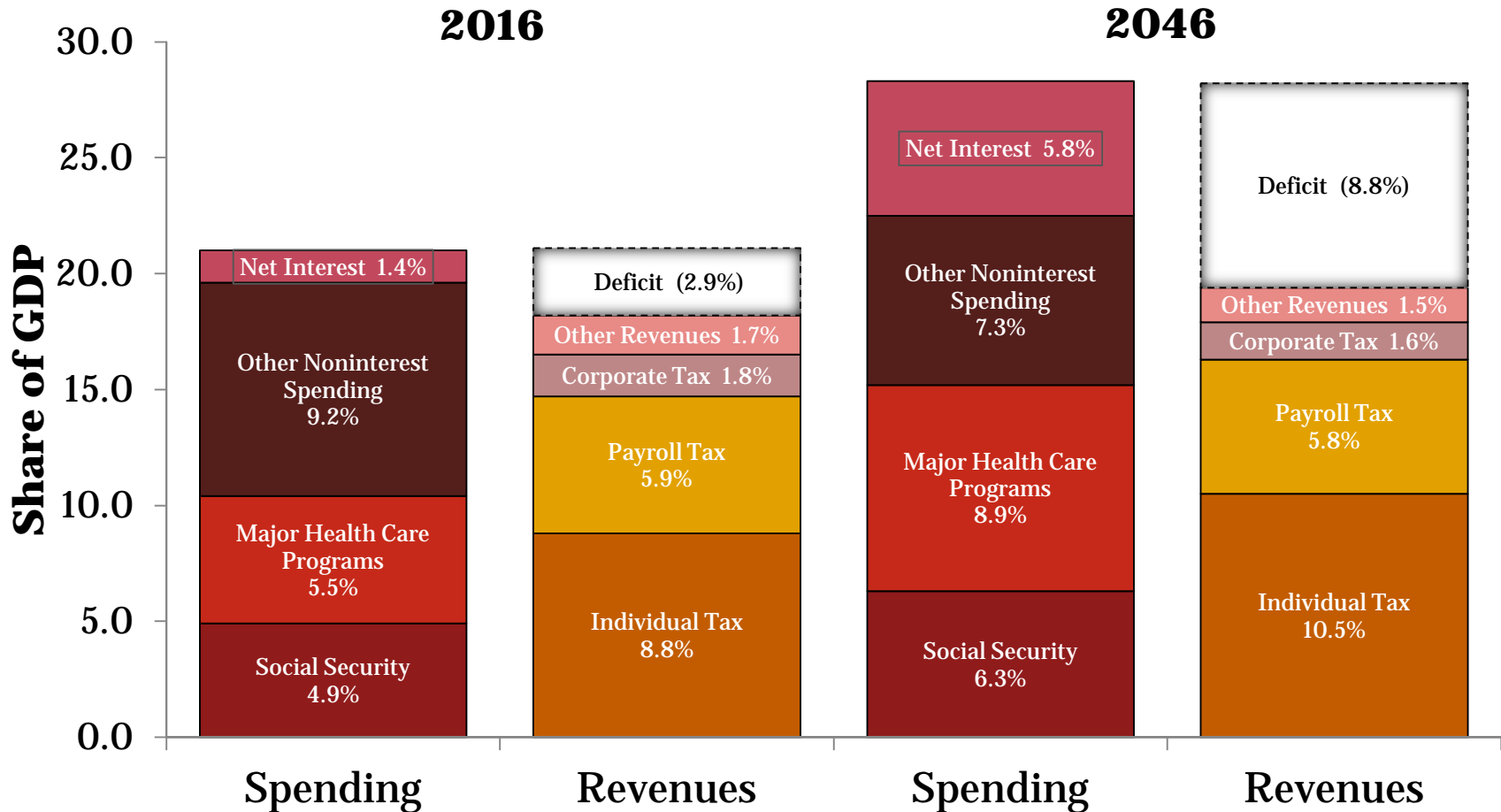
Regulatory tax issues

Business tax reform is an economic imperative ...



Sources: "Evolution of Territorial Tax Systems in the OECD," April 2, 2013; OECD Tax Database, "Part II. Taxation of Corporate and Capital Income. Table II. 1. Corporate income tax rate: Combined Central and Subcentral".

Worsening federal budget outlook favors difficult revenue-neutral tax reform over simply cutting taxes
Spending and revenues as a percentage of GDP



Source: Congressional Budget Office, *The 2016 Long-Term Budget Outlook* (July 2016).

Legislative paths available for tax reform in 2017

Regular legislative process

Benefits

- Legislation can be enacted permanently
- No artificial restrictions on which measures can be included

Limitations

- 60 votes needed at every step in the Senate (i.e., to begin debate, vote on amendments, vote on passage, to conference, etc).

Budget reconciliation process

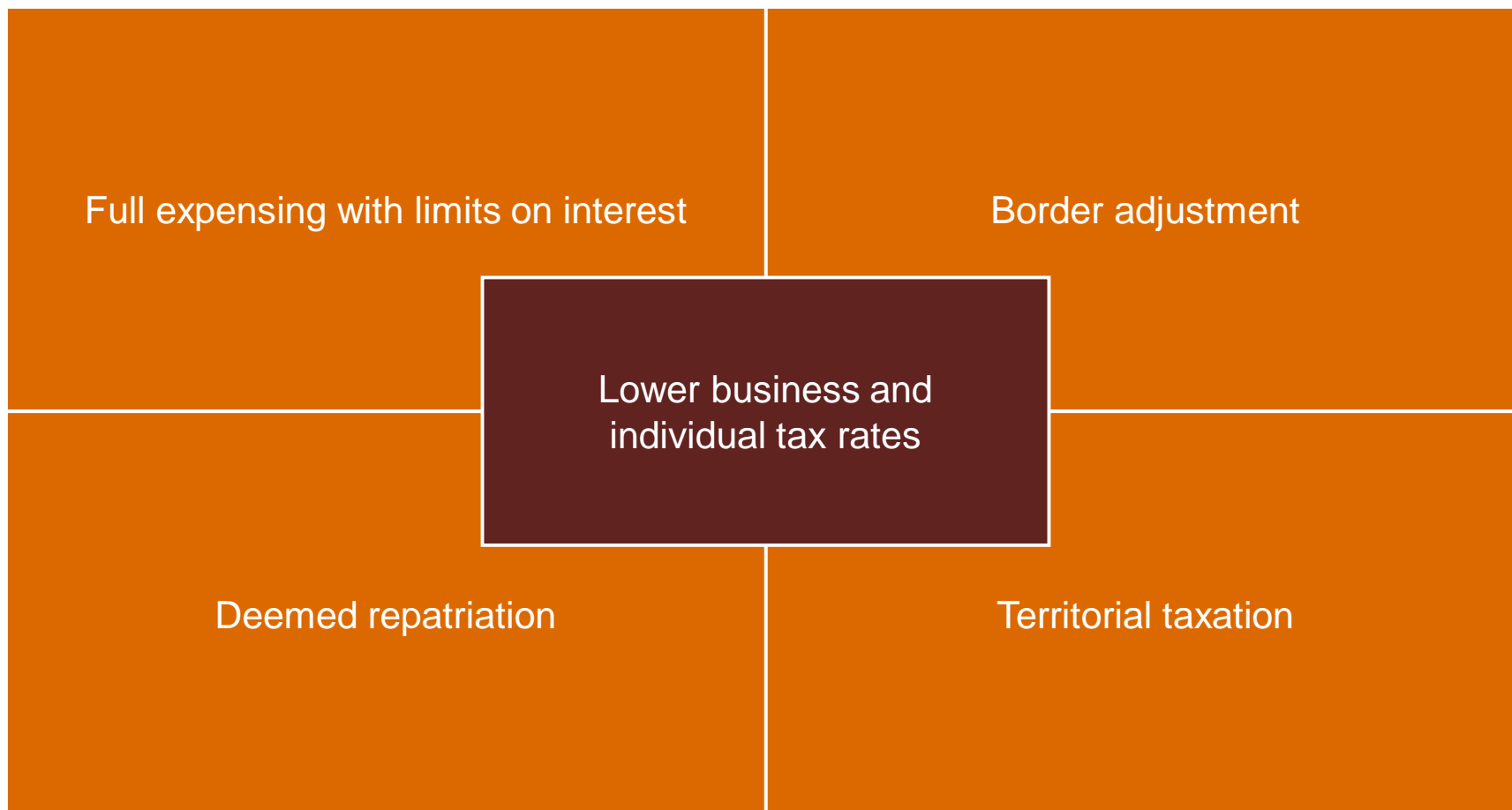
Benefits

- Requires only simple majority vote at every step in the Senate (no filibuster allowed)
- Expedited consideration (time limits for amendments and overall debate)

Key Limitations

- Legislation has to sunset if it is projected to lose revenue beyond the budget window (typically 10 years)
- 60-vote Senate super-majority required to waive sunset rule
- Senate rules also require reconciliation to be used only to enact measures that have a fiscal effect on the federal budget

Key elements of the House Republican tax reform blueprint



Comparison of recent tax reform proposals

Tax rate	Camp 2014 Tax Reform Act (H.R. 1)	House GOP 2016 tax reform 'blueprint'	Trump tax proposals
C corporations Rate	25% rate (phased in over 5 years)	20% rate	15%
Pass-through entities	(As current law)	25% maximum (combined entity and individual)	15% (within individual income tax regime); Distributions from large pass-throughs could potentially be subject to dividend tax
AMT	Repeal corporate and individual AMT	Repeal corporate and individual AMT	Repeals corporate AMT
Individual Rates	Three rate brackets (12%, 25%, 35%)	Three rate brackets (12%, 25%, 33%)	Three rate brackets (12%, 25%, 33%)
Capital Gain Rates	Tax as ordinary income with 40% exclusion	Tax as ordinary income with 50% exclusion; 50% exclusion also applies to interest	Maximum 28% rate
Carried Interest	Recharacterization needed for partnerships that are engaged in a trade or business of (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses (doesn't apply to a partnership engaged in a real property trade or business)	Not stated	Taxed at ordinary rates

Comparison of recent tax reform proposals

Other business reforms

	Camp 2014 Tax Reform Act (H.R. 1)	House GOP 2016 tax reform 'blueprint'	Trump tax proposals
Cost recovery	Repeal MACRS and implement ADS type system, with inflation adjustment	Full expensing for investments, excluding land	Businesses manufacturing in the US may elect full expensing for investments (revocable within the first 3 years)
Domestic production	Phase out and repeal Section 199 deduction	Repeal Section 199 deduction	Repeal Section 199 deduction
Interest expense	Limit for thin capitalization	Deductible only against net interest income; Special rules TBD for financial services	Businesses manufacturing in the US and electing full expensing for investments (see above) must forego interest expense deductions
R&D	Make alternative simplified credit permanent; Require 5-year amortization	Business credit to encourage research and development	Maintains R&D credit

Tax reform points of agreement / disagreement

Tax Reform Design Points	White House	House Republicans	Senate Republicans	House Democrats	Senate Democrats
Top individual rate reduction				/?	/?
Corporate rate reduction					
Special pass-through rate			?	/?	/?
Territorial				?	
Deemed repatriation					
Border adjustment	?	/?			
Anti-base erosion	?				
Expensing / interest	?		?		
Cap gains / dividend rate relief					
Estate tax repeal					
Dynamic scoring					?
Current policy baseline					?
Revenue neutral	/?				

Power & Utility Impacts of Tax Reform

- Rate change—excess deferred tax rules
- 100% expensing and interest deduction addback
- Border adjustability and other impacts
- Renewables impact

Changes in Tax Rates

- **Federal income tax rates have changed over the years**
 - **In “old days” close to 50%**
 - **Changed from 48% to 46% in 1979**
 - **Changed from 46% to 34% in 1987 (40% in 1986)**
 - **Changed from 34% to 35% (in 1993)**

Rate Change from 46% to 34%

- Transition provisions of 1986 tax act specifically addressed utility company deferred income taxes
- “Protected” ADIT—Refers to deferred income taxes protected by Internal Revenue Code
- These are the book/tax differences that the IRC requires utilities to normalize

Average Rate Assumption Method

Assumption illustration:

- Calendar-year taxpayer
- \$100,000 asset placed in service 1/1/86
- 3-year ACRS life, 5-year book life

Average Rate Assumption Method

Depreciation			
	Book	Tax	Difference
1986	\$20,000	\$25,000	\$5,000
1987	20,000	38,000	18,000
1988	20,000	37,000	17,000
1989	20,000	----	(20,000)
1990	20,000	----	(20,000)
	\$100,000	\$100,000	\$----

Average Rate Assumption Method

	Book/Tax Difference	Tax Rate	Tax Expense
1986	\$5,000	46.0	\$2,300
1987	18,000	40.0	7,200
1988	17,000	34.0	5,780
1989	(20,000)	???	???
1990	(20,000)	???	???
	\$----		\$----

ARAM applies when ADIT begins to reverse.

Average Rate Assumption Method

Deferred Tax Expense (86 – 88)	\$15,280
Total Book/Tax Difference (86 – 88)	\$40,000
Average Rate	38.2%

Under ARAM, use 38.2% to amounts reversing in 1989 and 1990.

Possible impacts to power and utilities companies Excess Deferred Income Taxes (EDIT)

Reduction of the tax rate from 35% to 20%

Assume “normalization” of property related deferred income taxes refunded to customers (similar to 1986 Act)

Assume a company has the following facts (ignoring the gross up)	Totals
Gross Plant temporary differences	5,000,000
Accumulated federal deferred income taxes @ 35%	1,750,000
Accumulated federal deferred income taxes @ 20%	1,000,000
Excess Deferred Income Taxes (to be refunded)	750,000

- EDIT established in a regulatory liability and refunded to customers over the remaining book life of the assets
- Reduces future revenue collected from customers
- Treatment of nonproperty deferred taxes?

Renewables and Investment Tax Credits

- **Wind Production Tax Credit (PTC)**
 - ✓ Commence construction standard 100% in 2016, 80% in 2017, 60% in 2018 and 40% in 2019
- **ITC's (Solar and Wind)**
 - ✓ Wind phase-out mirrors above
 - ✓ Solar – 100% of ITC through 2019, 26% credit in 2020 and 22% credit in 2021
- “Looking forward, we'd have to say everything is on the table. I don't want to cause any panic in the industry, but I think stating the reality that if you do 1986-style tax reform that in order to get the rates down we're going to have to make some significant changes.”

Senator John Cornyn, Majority Whip, BNA Daily Tax Report, 3/31/2017

Normalization Rulings and Rate Cases

- When forecast test period is used, to avoid a normalization violation, the IRS requires that the maximum amount of ADIT that can be used to reduce rate base (or that can be treated as zero cost capital in the capital structure) be 1) the amount of the ADIT at the end of the historical portion of the period and, 2) a pro rata amount of any projected increase to be credited to the account during the future portion of the period
- Following PLRs discuss deferred taxes in rate cases using future test periods:
 - PLR 9029040
 - PLR 9202029
 - PLR 9224040
 - PLR 9313008

Pro Ration Example (applies to projected portion of Test Yr. [mos. after effective date of new rates]

Projected Test Year ADIT additions \$120,000

ADIT Recorded

	Adds By Month	Days available	Pro Rated Adds	
January	\$10	350/365	\$9.59	
Feb	10	322/365	8.82	
March	10	291/365	7.97	
April	10	261/365	7.15	Substitute Pro Rated
May	10	230/365	6.30	Balances for projected
June	10	200/365	5.48	balances and be consistent
July	10	169/365	4.63	with Plant and Accumulated
Aug	10	138/365	3.78	Depreciation (end of period,
Sept	10	108/365	2.96	average). Pro ration is not
Oct	10	77/365	2.11	average.
Nov	10	47/365	1.29	
Dec	10	17/365	.46	
End of Period	\$120		\$60.54	

Normalization Rulings and Rate Cases

- Proration
 - PLR 201531010 & PLR 201532018: Computation of ADIT for purposes of calculating average rate base without application of the rules for future test periods
 - PLR 201541010: proration methodology is required

PLR - Proration and Normalization

PLR 201717008 (2017)

Facts:

- TP, transmits and distributes electricity and gas and is regulated by two state commissions
- TP had been calculating its Transmission Projected Rates and Transmission True-Up using a simple average of beginning and ending balances for the relevant rate year (i.e. TP did not apply the proration method required for future test periods)
- TP had been calculating its Rider Projected Rates and Rider True-Up using a simple average of beginning and ending balances for the relevant rate month (i.e. TP did not apply the proration method required for future test periods)
- Based on the Service's published rulings addressing similar circumstances, TP determined they were subject to the Proration Requirement

PLR - Proration and Normalization

PLR 201717008 (2017)

Conclusions:

1. Proration does apply
2. Don't need to average and prorate
3. Don't undue proration with true up
4. You might if doing so provides an absurd result

Normalization Rulings and Rate Cases

- **Bonus Depreciation Generating NOL's**
 - PLR 201418024 (unfavorable) (AN ANOMOLY)
 - PLR 201438003 (favorable)
 - PLR 201436038 (favorable)
 - PLR 201436037 (favorable)
 - PLR 201519021 (favorable)
 - PLR 201534001 (favorable)
 - PLR 201709008 (favorable)

Thank you

Contact me to discuss further:

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