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MEMORANDUM

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AZ CORP COMMISSION
DOCKET CONTROL

TO: Docket Control Center

FROM: Steven M. Olea
Director
Utilities Division

DATE: June 27, 2012

RE: **SUPPLEMENTAL STAFF REPORT** – FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTY THROUGHOUT THE STATE OF ARIZONA (DOCKET NOS. SW-20445A-09-0077, W-02451A-09-0078, W-01732A-09-0079, W-20446A-09-0080, W-02450A-09-0081 AND W-01212A-09-0082)

On January 4, 2011, at a Commission Staff meeting, the Commission directed Staff to conduct a workshop on the issue of imputed income taxes for Subchapter S Corporations ("S-Corps") and Limited Liability Companies ("certain LLCs") that are not subject to taxes as C Corporations. The Commission directed Staff to conduct this workshop[1] as part of the compliance filing in Commission's Decision No. 71878.

Attached is the Supplemental Staff Report, pursuant to the compliance filing ordered in the above-named docket, that discusses the issue of imputed income taxes for S-Corps and LLCs that are not taxed as C Corporations, whether by default or by electing to be taxed as C Corporations. This report provides Staff's recommendations regarding the imputation of income taxes for S-Corps and certain LLCs.

Staff recognizes that the process for determining the appropriateness of imputing income tax expense as a component of the revenue requirement for entities that have no direct income tax obligation such as S-Corps and LLCs is a policy issue for the Commission.

Staff recommends continuation of the Commission practice to not recognize income taxes as a component of the cost of service when utility services are rendered by an entity classified as an S-Corp or certain LLCs.

Arizona Corporation Commission
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[1] Workshop was conducted in Docket No. W-00000C-06-0149 in which a copy of this report is also filed.

In the alternative, if the Commission is inclined to allow S-Corps and LLCs to collect an imputed income tax from rate payers, Staff recommends using the methodology discussed in this report.

SMO:GWB:red

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Docket Nos. SW-20445A-09-0077 et al.

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

SUPPLEMENTAL STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTY THROUGHOUT THE STATE OF ARIZONA

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INTRODUCTION

Decision No. 71878 also ordered that stakeholders, including the Commission Utilities Division ("Staff") and Global, investigate various ways to achieve the Commission's objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. The investigation was to be conducted through workshops in generic Docket No. W-00000C-06-0149. Subsequently, the Commission directed that these workshops also examine the merits of imputing income tax expenses to Subchapter S Corporations ("S-Corps") and to Limited Liability Companies ("LLCs") that are not taxed as C Corporations, whether by default or by not electing to be taxed as C Corporations ("certain LLCs").

To comply with the Commission's direction, on March 25, 2011, Staff conducted a workshop on the issue of imputing income tax expenses to S-Corps and LLCs. Participants at the workshop included Staff, stakeholder companies, Residential Utility Consumer Office ("RUCO") and various parties. Parties were given the opportunity to discuss and present their issues. Staff took into consideration, comments made at the workshop and comments filed with Docket Control. After careful consideration, Staff continues to recommend that income tax expense is not a cost of service incurred by S-Corps and certain LLCs, therefore, it should not be included in rates. Staff continues to recommend that the Commission maintain its policy that was adopted in Decision Nos. 71445, 72579 and 73160.

The purpose of this supplemental Staff Report is to present Staff's recommendations regarding the imputation of Income Tax for S-Corps and certain LLCs.

STAFF ANALYSIS

On May 4, 2005, the Federal Energy Regulatory Commission ("FERC"), reversed its previous position and decided to allow recovery in rates for income tax expenses that are "attributable to regulated service."[1] FERC concluded that "a taxpaying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, have an actual or potential income tax liability on that public utility income."[2]

The FERC statement further clarified its opinion:

> *In retrospect, it was the Commission's failure to distinguish between first and second tier income that lead to the double taxation rationale that the Commission incorrectly advanced in Lakehead. Dividends paid to the common stock investor and by the corporate investor in a pass-through entity are second tier income to*

[1] Policy Statement on Income Tax Allowances at 13, para. 33, 111 FERC ¶ 61,139 (2005).
[2] Id. at 12, para. 32.

> *such a common stock investor. As such, an income tax is paid by the investor in addition to the corporate tax that is due on the first tier income. In contrast, first tier income flows either to the corporation, a corporate partner, or individual partners (or LLC members) and is taxed at that level. To the extent Lakehead either concluded or assumed that dividend payments and income, and partnership distributions and income, have the same ownership and income tax characteristics, this is simply incorrect as a matter of partnership and income tax law.*[3]

FERC alleges that income from an S-Corps has a tier one classification, even though the income automatically and uncontrollably flows to investors who bear the tax burden, if any.

In Staff's view, the basis of including income tax expense in rates is the proven and demonstrable existence of taxation at the entity level. Since there is no evidence that an income tax liability is actually borne by S-Corps or certain LLCs, income taxes are not rightly chargeable to the ratepayers. Staff concludes that it is not in the public interest to require Arizona ratepayers to pay the personal income tax liabilities of utility owners' pass-through distribution of utility income.

Moreover, Staff is also concerned with FERC's seemingly arbitrary classification of S-Corp earnings as tier one, as well as with FERC's conclusion that income taxes are appropriate because those earnings are "attributable to regulated service."[4] Providing for income tax expense for taxes paid by the recipients of pass-though income would be analogous to paying for the taxes borne by shareholders of C Corporations for dividends received and places an unfair burden on the ratepayers. Staff has searched the federal tax code and could not find any authoritative definition of "tier one" or "tier two" earnings as it would relate to this topic. Thus, heavy reliance on these terms is ill advised, as FERC or another agency could conceivably interpret dividends paid to shareholders of C Corporations as also being tier one, resulting in an obligation for ratepayers to pay the taxes on that income as well.

Further, FERC's statement relies largely on commenters to the FERC docket who assert that, even though the pass-through entity does not itself pay income taxes, the taxes nevertheless exist simply because the income on which the owners bear a tax burden originated from the regulated entity.[5] However, Staff was unable to locate documentation from either the commenters or FERC to explain whether or how shareholders of a C Corporation who pay taxes on dividends received are or would be made whole using this underlying premise. Thus, the premise is inconsistently applied.

Although Staff respects the rulings of other regulatory agencies, Staff recommends that the Commission consider this issue on its own merits and continue its current policy, by not including an allowance for income tax expense in the rates of utilities operating as S-Corps or

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[3] Id. at 16-17, para. 38.
[4] Id. at 13, para. 33.
[5] Id..

certain LLCs. Allowing a provision in rates for income tax expenses paid by the recipients of pass-though income would be analogous to including in rates the income taxes borne by shareholders of C Corporations for receipt of dividends. Such treatment effectively increases the rate of return to investors in excess of the stated, or intended, authorized rate. As a result, the authorized rate of return would neither be representative of the actual authorized return nor comparable to other utilities with similar risk. The resulting rates would place an unfair burden on the ratepayers and may not meet the fair and reasonable standard, since ratepayers will be expected to pay more without any incremental demonstrable benefits to them.

Considerations Related to These and Other Forms of Business Entities

Requests to the Commission thus far for the inclusion of an imputed income tax allowance in rates have overwhelmingly been brought forward by utilities organized as either S-Corps or certain LLCs, but if approved, the allowance for income taxes should also include other business entity forms such as partnerships not operating as an LLC and sole proprietorships.[6]

Another common form of ownership is the C Corporation. The Commission should also address the inequities that would result to the owners of utilities taxed as C Corporations as a consequence of providing an income tax allowance to the owners of S-Corps and certain LLCs, since under present ratemaking treatment, the shareholders of C Corporations are not reimbursed for the taxes they pay, while owners of S Corporations and certain LLCs would be if the Commission approves the inclusion of income tax expense for these entities.

While creating inequities to both the shareholders of C Corporations and for ratepayers, as discussed above, the implications of the proposal clearly demonstrate the fallacy that pass-through entities should be allowed an imputed income tax expense. Accordingly, any changes to the methodology used to calculate the income tax expense or allowance for all types of business entities should be evaluated simultaneously.

Staff believes the Commission should take into consideration the unintended consequency, and how this will affect other regulated Companies.

CONCLUSIONS AND RECOMMENDATIONS

Staff concludes that taxes on income from pass-through entities,(S Corps, certain LLCs, partnerships not operating as LLCs and sole proprietorships) represent the personal income tax obligations of the owners of those businesses.

Staff further concludes that it is not in the public interest to require Arizona ratepayers to pay the personal income tax liabilities of utility owners' pass-through distributions of utility income.

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[6] Id at 1, para 1. The FERC policy includes income tax allowance for "similar pass through entities" which would include partnerships not operating a LLCs and sole proprietorships.

Staff recommends continuation of the Commission practice to not recognize income taxes as a component of the cost of service when utility services are rendered by an entity classified as an S-Corp or certain LLC. However, Staff realizes that the recognition or not of income taxes for S-Corps and certain LLCs is a policy decision for the Commission, therefore, if the Commission approves an income tax allowance for S-Corps and certain LLC's, the methodology to calculate the allowance should consider the Alternative described below, and should be implemented concurrently with and only after the Commission determines the changes, if any, that are warranted to the methodology used to calculate income tax expense for C Corporations.

ALTERNATIVE ALLOWING INCLUSION OF INCOME TAXES FOR S-CORPS AND CERTAIN LLCS

If the Commission disagrees with the above recommendation and wishes to allow S-Corps and certain LLCs ("regulated entity") to collect imputed income taxes from ratepayers, Staff recommends doing so only with the following minimum conditions/requirements:

a. A requirement that the regulated entity provide detailed information about its owners, to include the number and type of owners and each owner's pro-rata share of regulatory income.

b. A requirement that the regulated entity provide copies and supporting documentation, as deemed necessary by Staff, of each owner's income tax returns for the past three years so that an effective tax rate can be calculated for each owner's share of the regulated income. If any owner of the regulated entity is another S-Corp or LLC, that owner must provide copies of all requested tax returns for each direct and indirect recipient of income from the regulated entity. In the event that information is not received or is inadequate to calculate each member's personal tax rates, the default rate for the portion of the imputed income tax expense shall be zero.

c. A requirement that each owner file proof of payment for Federal and State income tax return liability for returns filed in compliance with item b above. If proof of payment is not provided or is not available, the owner may file a notarized, sworn statement attesting that the tax returns filed are a true and accurate copy of the tax returns filed with the taxing authority.

d. A determination that the regulated entity be authorized a lower rate of return on rate base. Since an income tax allowance for S-Corps and certain LLCs provides tax-free utility income to the shareholders/members, a lower rate of return is warranted to reflect the "tax-free" status of that income in a manner similar to the lower yield of tax-free versus taxable bonds with the same rating.

e. Any other conditions/requirements the Commission deems appropriate.