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July 20, 2012

AZ CORP COMMISSION
DOCKET CONTROL

Gary Pierce, Chairman
Bob Stump, Commissioner
Sandra Kennedy, Commissioner
Paul Newman, Commissioner
Brenda Burns, Commissioner
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Re: Docket No. W-00000C-06-0149

Dear Chairman and Commissioners:

At the July 18/19 Open Meeting, I spoke in favor of allowing the income tax expense in rates for pass-through tax entities. I want to again thank the Commission for facilitating this policy debate and public participation thorough this generic docket.

Since consideration of the Policy Statement Regarding the Treatment of Income Tax Expense for Pass-Through Entities has been deferred pending resolution of an ongoing rate proceeding, I am writing this letter to formally place into the record my comments made verbally at the Open Meeting.

I am also attaching a copy of a presentation made by me at Staff's workshop held in this proceeding on March 25, 2011, which has not previously been docketed.

Sincerely,

Ray L. Jones, P.E.

Arizona Corporation Commission
DOCKETED

JUL 23 2012

DOCKETED BY

Attachment 1

Comments of Ray L. Jones, P.E.
Docket No. W-00000C-12-0270
Income Tax Policy for Pass-Through Entities
Presented July 19, 2012
Open Meeting of the Corporation Commission

Mr. Chairman, Commissioners, thank you for the opportunity to speak. I am Ray Jones consultant to several water companies affected by this issue and have actively participated in this docket.

This is an important Policy Decision before Commission today. In my 25 years before this Commission there have been far too few policy debates as public and thorough as this one. I believe these debates are healthy and allow policy decisions to rise above the issues and politics of an individual case. I applaud the Commission for recent policy focus and thank the Commission for the opportunity to participate.

This process stands in stark contrast to the 1988 process that put the current income tax policy in place. In 1988, the Commission eliminated income tax for pass-through entities over the opposition of all parties to the Consolidated Water case, including ACC Staff, and without any public discussion of the policy. That hastily adopted policy stands today, some 24 years later.

The arguments for a change in policy are clear and convincing. A Change encourages needed investment in infrastructure, which is particularly important for struggling small water companies. A change promotes tax efficiency, lowering costs for both customers and owners in the long-run. Lower taxes for pass-through entities are a "Win-Win" that should be supported by all parties. A change eliminates rate discrimination between C-Corps and pass-through entities.

RUCO and Staff both oppose the policy change. RUCO and Staff's primary argument is that the taxes are a personal expense and should not be included in rates and that the tax liability may not exist, the so called "phantom" tax argument. These concerns are misplaced.

Pass-through businesses play an important and increasing role in the US and Arizona economies. In 2008 Pass-through entities accounted for more than 90% of business entities, employed 54% of the private-sector workforce and reported 34% of all business receipts.¹

¹ *The Flow-Through Business Sector and Tax Reform*, Ernst & Young, April 2011

**Comments of Ray L. Jones, P.E.
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In the five-year period from 2004-2008, pass-through entities received 54% of all business net income and, most importantly, paid 44% of all business income taxes.²

Clearly, pass-through business income and income taxes are real and substantial. Staff and RUCO's argument that they are personal expenses or that they do not exist fly in the face of economic reality and are unsupported by the evidence.

Furthermore, the Commission has recognized this economic reality subsequent to adopting the 1988 policy. In 1997, the Commission allowed Camp Verde Water Company to collect pass-through income tax in its rates. In that case, a bank would not loan Camp Verde much needed funds because the revenues proposed by the Commission would not be sufficient to both pay back the loan and pay the income taxes generated by the utility income. In the end, the Commission, just like the bank, recognized the economic reality of income taxes paid by the owners of pass through entities and allowed income taxes in rates.

The economic realities made apparent in the Camp Verde case are the same in every case and are best summarized in the words of the Texas Supreme Court.

The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a corporation.

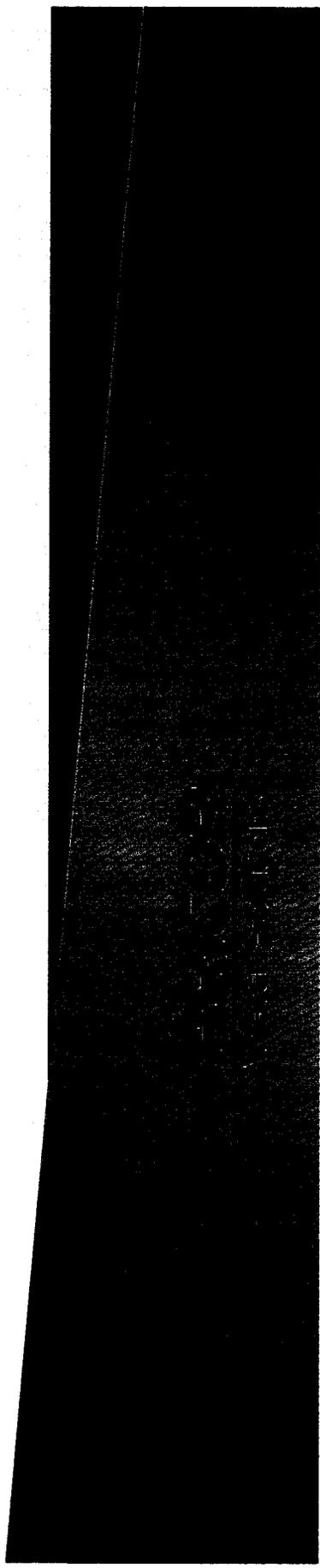
In conclusion, maintaining the current policy is a short-term gain that will result in long-term pain. The Commission should focus on long-term and adopt a much needed change to its income tax policy for pass-through tax entities.

² *Ibid.*

Attachment 2

Arizona Corporation Commission

Recovery of Income Tax Expense:
Partnerships, S-Corps, and LLCs



Income Tax Basics

- ▶ Although taxed differently the income of all utilities is subject to taxation.
- ▶ Utility income is taxed differently depending upon the form of business enterprise.
 - The income of standalone C-Corps is taxed at the corporate level with shareholders being individually taxed on distributions from the corporation.
 - The income of Sole Proprietorships, Partnerships, S-Corps and most LLCs are taxed at the shareholder level whether or not the income is distributed to the shareholder. Distributions are not subject to additional taxation.
 - The income of subsidiary C-Corps is typically consolidated by the ultimate corporate parent, where it is netted against income and/or losses from other subsidiaries. Like Partnerships, S-Corps, and LLCs, dividends to the parent shareholder are not taxable.

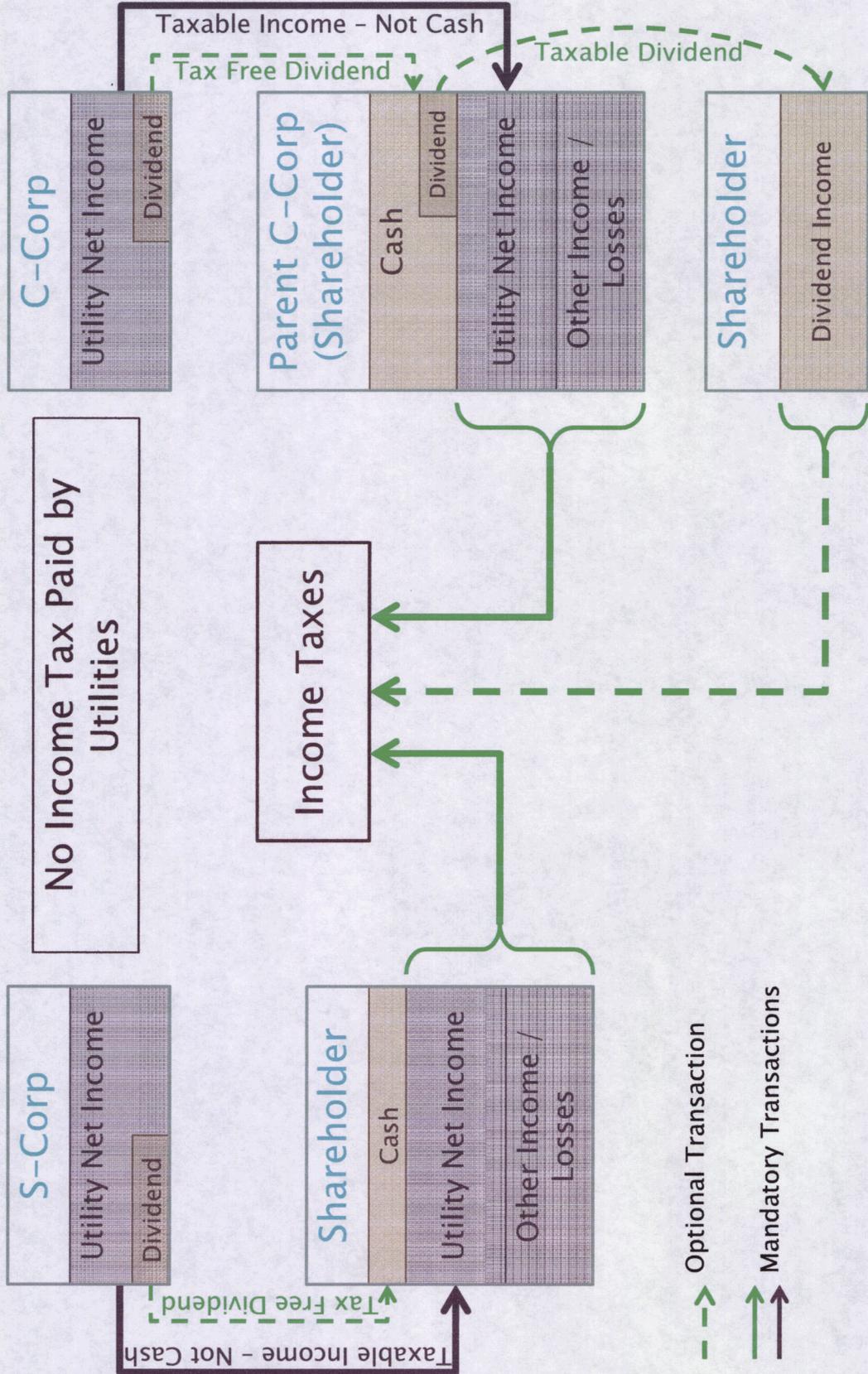
Income Tax Basics

- ▶ Most large Arizona utilities are C-Corps that are part of consolidated tax groups. They are taxable entities, but do not pay income taxes.
 - Rather their taxable income is consolidated at the parent company level, with income taxes due, if any, being paid by the parent corporation.
 - APS/Pinnacle West; TEP/UniSource; Arizona-American/American Water; Global Utilities/Global Water
- ▶ Many Arizona Utilities are actually operating divisions of C-Corps. They do not pay income taxes.
 - Rather their taxable income is consolidated first with other operating divisions and ultimately consolidated at the parent company level, with income taxes due, if any, being paid by the parent corporation.
- ▶ All of these C-Corp entities recover income tax expense in their rates set by the Commission.

Commission Income Tax Treatment of C-Corps

- ▶ Standalone C-Corp
 - Hypothetical income tax expense is calculated and allowed in rates.
 - Rate of Return based on after tax net income.
- ▶ Consolidated C-Corp and/or Operating Division
 - Hypothetical income tax expense is calculated and allowed in rates.
 - Income tax calculated as if the utility was a standalone C-Corp.
 - Actual tax liability of parent, if any, is not considered.
 - Rate of Return based on after tax net income

Income Tax Flow Chart



A Matter of Policy

- ▶ The ratemaking treatment of income tax expense is a policy decision made by the Arizona Corporation Commission.
- ▶ The Commission should not limit its consideration to technical and accounting distinctions.
- ▶ The Commission should consider economic reality.
 - Partnership, S-Corp and LLC income is taxed and is paid from utility income.

A Matter of Policy

- ▶ The Commission should not unfairly discriminate against partnerships, S-Corps or LLCs in favor of C-Corps.
 - Hypothetical income tax calculations are used for C-Corps. They should be allowed for partnerships, S-Corps and LLCs.
 - For many C-Corps the regulated entity does not pay income taxes, rather the income tax liability is passed through to the parent company, which may or may not actually pay income taxes.
 - There is no justifiable reason to allow APS, TEP or Arizona-American Water to recover hypothetical tax expense and to deny partnerships, S-Corps or LLCs similar treatment.
- ▶ Disallowance of income taxes reduces the allowed return on rate base and reduces the funds available for plant investment.

Lower Rates of Return

	S-Corp		C-Corp	
	Utility	Shareholder	Utility	Shareholder
<u>Income</u>				
Revenue Requirement	1,414,000		1,414,000	
Tax Gross Up	0		57,367	
Revenue Requirement	1,414,000		1,471,367	
Owner Salary	(65,000)	65,000	(65,000)	65,000
Other Expenses	(1,235,000)		(1,235,000)	
Operating Income	114,000		171,367	
Income Tax (Business)		(31,426)	(57,367)	
Income Tax (Owner)		(7,538)		(7,538)
Net Income	114,000	26,036	114,000	57,462
<u>Rate Base and Return</u>				
Rate Base	1,140,000		1,140,000	
ROR (Pre Tax)	10.0%		15.0%	
ROR (Post Tax)	7.2%		10.0%	

Less Cash Available for Investment

	S-Corp		C-Corp	
	Utility	Shareholder	Utility	Shareholder
<u>Cash Flow</u>				
Net Income	114,000	26,036	114,000	57,462
Depreciation	400,000		400,000	
Available Cash	514,000	26,036	514,000	57,462
Dividend for Taxes	(31,426)	31,426		
Net Available Cash	482,574	57,462	514,000	57,462

Arizona Allowance of Income Tax

- ▶ Allowed for partnerships and S-Corps prior to Consolidated Water Decision No. 55839 (1/8/88).
 - Corporate tax rate allowed previously.
 - Staff recommended moving to new lower individual rate.
 - Commission allowed no income tax in rates.

- ▶ Subsequently has been periodically allowed.
 - Fisher's Landing Water and Sewer Works, LLC (6/26/02).
 - Winchester Water Company, LLC (9/24/02).
 - Wickenburg Ranch Water, LLC (2/12/09).
 - Staff classifies these cases as errors.

- ▶ Allowed in Camp Verde Water System, Inc. Decision No. 60105 (3/19/97).

Camp Verde Decision No. 60105

› From Decision No. 60105 –

At the hearing, the Company indicated that CoBank would not loan the Company money unless the rates approved herein would provide for income taxes that would be paid by the individual shareholders.

Under the circumstances presented herein, we are not going to adjust the rate of return for income taxes as requested by the Company. We are going to allow income taxes in this case at the lowest individual/corporate income tax rates of 23.36 percent for combined Federal and State income taxes.

› The Camp Verde case highlights the economic reality that S-Corps have real income tax expenses. Because the bank's investment would only be repaid with after-tax dollars, it insisted on recovery of income-tax expense in rates. The Commission acknowledged economic reality and allowed Camp Verde to recover expected income-tax expense.

› Put another way, only the funds left over after paying taxes and other business expenses are available to fund additional plant investment or make debt payments. If income-tax expense is not recoverable, the effect is to reduce the allowed return on rate base and diminish the funds available for plant investment.

Summary

- ▶ Public policy should be based on economic realities and fairness rather than technical and accounting distinctions.
- ▶ It is good public policy to allow income tax recovery for partnerships, S-Corps and LLCs.
 - Partnerships, S-Corps and LLCs are not unfairly discriminated against.
 - Partnerships, S-Corps and LLCs receive the same return on rate base as C-Corps.
 - Partnerships, S-Corps and LLCs have the same funds available for plant investment.
- ▶ The Commission recognized the economic realities of income taxes in the Camp Verde decision and allowed income taxes for an S-Corp.

Final Thought

“The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a corporation.”

Supreme Court of Texas