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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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Arizona Corporation Commission
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FEB 11 2013
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IN THE MATTER OF A POLICY STATEMENT
ON INCOME TAX EXPENSE FOR TAX PASS
THROUGH ENTITIES.

Docket No. W-00000C-06-0149

RUCO'S COMMENTS

The Residential Utility Consumer Office ("RUCO") files these comments in response to the Commission's consideration of a Policy Statement that would change the current policy to allow tax recovery for pass-through entities.

I. INTRODUCTION

RUCO urges the Commission to not change its current policy which excludes the recovery of income taxes to pass-through entities (S Corporations and LLCs). Simply stated, a Commission policy which would allow pass-through entities to recover from ratepayers taxes that these utilities do not pay is bad public policy.

Commissioner Pierce submitted a draft policy statement ("draft policy") to stakeholders on June 15, 2012. The draft policy expressed numerous concerns with the current policy claiming that it "needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. Neither of these outcomes serves the interests of ratepayers." With all due respect each one of these

1 concerns is empty, and changing the current policy would not serve the ratepayer's
2 interests.

3 Among other things, a change in the current policy will unquestionably raise
4 ratepayer's rates and result in unintended consequences. At a time when the Commission
5 has its hands full dealing with the public perception of its energy efficiency and renewable
6 energy polices, RUCO hopes that the Commission will give serious consideration to the
7 public perception of a new policy that will result in higher rates because ratepayers will be
8 required to pay a utilities taxes that the utility does not pay.

9
10 **II. THE CURRENT POLICY DOES NOT DISCRIMINATE BECAUSE PASS-
11 THROUGH CORPORATIONS ARE NOT THE SAME AS C CORPORATIONS.**

12 The LLC/S Corporations and the C corporations are two different types of corporate
13 entities for tax purposes and the Commission should not treat them as if they are the
14 same. The LLC and S Corporation do not pay income tax and elect that form of
15 organization to avoid double taxation. The C Corporation does pay income tax and elects
16 that form of organization for other reasons such as avoiding the maximum shareholder
17 requirement of the S corporation. Trying to treat these two different forms of corporate
18 organization the same is as Commissioner Brenda Burns once said "trying to fit a square
19 peg in a round hole".

20 Ironically, in the draft policy's quest for parity, the result of a policy change will be
21 even more disparity – in both cases the investors would provide capital resulting in utility
22 operating income, but only the C corporation will pay the income taxes on the operating
23 income prior to distributing dividends to its investors who will then pay income taxes on
24 those dividends.

1 If one were to believe that the current policy “needlessly discriminates”- surely the
2 solution would not be to implement a policy that will “needlessly discriminate” against C
3 corporation shareholders (i.e. C Corp. shareholders do not currently recover their personal
4 income taxes from ratepayers) – two wrongs do not make a right. But more importantly,
5 how is it that the current policy that does not reimburse the S Corporation for income taxes
6 it does not pay by its own election, but does allow recovery to a C corporation for income
7 taxes it does pay discriminate in any way, shape or form? Actually it is the draft policy
8 that would discriminate. Hence, an unintended but very real consequence of the draft
9 policy will be that the C Corporations will request that their shareholder’s be reimbursed for
10 the personal income taxes they pay. This will undoubtedly put the Commission in a very
11 tight spot – for how can the Commission then distinguish the two situations?

12 Another reason why the two are not the same concerns Accumulated Deferred
13 Income Tax (“ADIT”). When a C Corporation comes in for rate relief, there is an ADIT
14 calculation associated with the corporate income tax. ADIT, which typically is booked as a
15 liability, is also a deduction to ratebase. A deduction to ratebase benefits the ratepayers.
16 With S corporations, an ADIT calculation is not necessary since there is no corporate
17 income tax. The Commission’s new policy will impute an income tax based on the
18 shareholder’s personal income tax which will ignore ADIT¹ as the calculation is made
19 solely for the purpose of ascertaining the shareholder’s recovery of personal income tax
20 from ratepayers and not to ascertain corporate income tax liability. Ratepayer’s will get the
21 short end of the stick again.

23 ¹ The ADIT calculation in a newly filed rate case will apply prospectively since a Company will not have
24 collected any income taxes in rates in the past as an S corporation or an LLC. Nonetheless, it still remains a
valid concern.

1 **III. THE CURRENT POLICY DOES NOT CREATE AN ARTIFICIAL IMPEDIMENT TO**
2 **INVEST IN UTILITY INFRASTRUCTURE IN ARIZONA.**

3 The draft policy purports to stimulate growth but there is no evidence that the
4 current policy acts as an impediment to growth. To the contrary, since the 1980s when the
5 Commission established its policy to deny recovery of personal income taxes of
6 shareholders of pass-throughs, there has been an increase in the number of utilities
7 switching to or organizing as pass-throughs. Particularly after the passage of Tax Reform
8 Act of 1986, utilities have chosen to take advantage of the tax benefits afforded by S
9 corporations and LLCs.

10 Arizona water/wastewater utilities have experienced phenomenal customer growth
11 in the last few decades. The need for additional infrastructure has been a challenge.
12 Additionally, water utilities have had to comply with the federal Safe Drinking Water Act,
13 the Arizona Groundwater Code, and tougher EPA arsenic standards. Arizona's utilities
14 have risen to the challenge and have done so without changing their corporate status.
15 Some utilities, like Pima are built out, so it is difficult to appreciate the argument that
16 allowance of recovery of personal income taxes will incent needed infrastructure when
17 those utilities were able to meet the infrastructure demands when the challenge was the
18 greatest without choosing to change their corporate status.

19 The Commission's policy will not spur investment in Arizona. The S corporation
20 status allows utilities to avoid double taxation – paying corporate income taxes on
21 revenues and also personal income taxes on the after-tax dividends. It allows start-ups to
22 raise capital and lower their capital needs which even Pima's Senior Vice President and
23
24

1 Chief Financial Officer, Mr. Steven Soriano explained was a benefit in the Pima case.²
2 These benefits are the attraction of organizing as an S corporation, not the Commission's
3 policies.

4
5 **1. THE CONCERN THAT PASS-THROUGHS WILL SWITCH TO C**
6 **CORPORATIONS AND RATEPAYERS WILL PAY HIGHER TAXES IS**
7 **ANOTHER EMPTY CONCERN.**

8 Related to the investment argument is the concern that if utility customers do not
9 cover the pass-through shareholders personal tax liability, then the pass-throughs will elect
10 to reorganize as a C corporation. The maximum corporate income tax rate is higher than
11 the maximum individual income tax rate. A C corporation is subject to corporate income
12 tax. The concern is that since the maximum corporate income tax rate is higher than the
13 individual income tax rate, the ratepayers would pay even higher rates if the rates included
14 recovery for corporate income taxes rather the personal income taxes.

15 **A. THE COMMISSION NEED NOT CHANGE ITS POLICY TO**
16 **ATTRACT INVESTORS.**

17 In the Pima case, former Commissioner Spitzer explained why on the FERC level
18 there was a need to attract investors. Mr. Spitzer noted that the gas pipelines were
19 desperately needed throughout the country, and the investment community had made it
20 clear that they did not want to invest in the C corporations - they wanted to invest in the
21 pass-through corporations. FERC's intent was to encourage investment in desperately
22 needed gas pipelines.

23 In Arizona, there is a completely different set of circumstances. With many water
24 utilities, such as Pima, the utility is built out so infrastructure investment is not a concern.

² See Direct Testimony of William Rigsby at 6 in Docket No. W-02199A-11-0329.

1 Second, with FERC the question centered on desperately needed gas pipelines. In
2 Arizona, the concern is water, not gas pipelines, and there is no air of desperation. Finally,
3 there is no evidence that the Commission's current policy has pushed investors to C
4 corporations. In fact, according to Mr. Spitzer, the evidence would indicate otherwise. Mr.
5 Spitzer testified that most new entities are formed as pass-through LLCs. At the time Mr.
6 Spitzer was an Arizona Commissioner, he testified that the ratio was approximately 100 to
7 1 and has probably gotten larger³. When asked if he was aware of any entities organized
8 as a C corporation because of the Commission's policy he testified that he was not aware
9 of any⁴.

10 Mr. Spitzer's testimony is consistent with Staff's witness, Mr. Carlson who also
11 testified that he had no knowledge of utilities converting to C corporations because of the
12 Commission's long standing policy and could not even recall a single entity organized as
13 an S corporation that converted to a C corporation⁵. The concern is unfounded because
14 S Corporations provide the major benefit of avoiding double taxation which remains
15 regardless of the Commission policy. Pima is a prime example of a pass-through utility
16 that has not changed its corporate status since the mid-80s in spite of the Commission's
17 policy because of the tax advantages implicit with its pass-through status.

18
19 **IV. THE DRAFT POLICY WILL RAISE RATEPAYERS RATES SIGNIFICANTLY.**

20 The effect on ratepayers of the draft policy will be to raise their rates significantly in
21 most cases. At the Commission's Open Meeting held on July 19, 2012, RUCO discussed
22 with the Commission the effect of such a policy. In response to then Commissioner
23

24 ³ See Transcript of Hearing in the Pima case at 186, Docket No. W-02199A-11-0329.

1 Newman's comments about how such a policy would raise rates, RUCO explained that at
2 that time there were at least three utilities, Johnson, Sahuarita, and Sunrise that were likely
3 waiting to file 252 applications and one utility, Pima, which at that point had a pending rate
4 application seeking pass-through recovery of income taxes⁶. Based on the filings of the
5 four companies, RUCO had determined that a change in policy would have the combined
6 effect on a total of 40,000 customers of over \$2,000,000 in increased cost. Moreover, a
7 change in policy will undoubtedly result in requests from other Arizona pass-through
8 Company's for the recovery of income taxes including Saddle brook (4,800 customers),
9 Sunrise, Tonto Creek, and Naco Water and on and on. The draft policy will result in a lot
10 of ratepayers in Arizona seeing their rates increase to allow utilities to recover income
11 taxes those utilities do not even pay.

12 **V. THE DRAFT POLICY IS LIKELY TO HAVE UNINTENDED CONSEQUENCES.**

13 **1. INCREASING RATES TO COVER SHAREHOLDERS' PERSONAL**
14 **INCOME TAX LIABILITY MAY RESULT IN AN UNJUST ENRICHMENT**
15 **TO SHAREHOLDERS IF NO TAXES ARE ACTUALLY OWED.**

16 As mentioned above, the shareholders of the C Corporation will undoubtedly
17 complain that the new policy discriminates against them. Another unintended consequence
18 concerns the tax imputation. Since shareholders may offset tax liability for income earned
19 with losses from other S corporations or other investments as well as other deductions,
20 credits and exemptions, it is quite possible that monies collected for the shareholders' tax
21 liability will exceed the amount of tax actually owed. For example, a shareholder of a

22 ⁴ See Transcript of Hearing in the Pima case at 186 - 187, Docket No. W-02199A-11-0329.

23 ⁵ See Transcript of Hearing in the Pima case at 308, Docket No. W-02199A-11-0329.

24 ⁶ Since the Open Meeting Pima's application has been decided and Pima has chosen to wait until the
Commission decided its policy before moving forward on this issue – see Decision No. 73573.

1 profitable S corporation utility who also realized losses from ownership of a real estate
2 development business can apply those losses to offset earnings derived from the utility.
3 Additionally, a shareholder can apply numerous exemptions, deductions and tax credits
4 that are available to the individual taxpayer but not to a corporation. Examples include
5 exemptions for minor children, deductions for health savings accounts, moving expenses,
6 student loan interest, child tax credit, dependent care tax credit, residential energy credits,
7 and retirement savings credit.

8 The result would be essentially free money for the shareholders paid by the
9 ratepayers who receive no benefit from these payments.

10
11 **A. IF THE COMMISSION DECIDES TO CHANGE THE POLICY,
12 THE COMMISSION SHOULD IMPUTE TAX RECOVERY BASED
ON SHAREHOLDERS ACTUAL INCOME TAX LIABILITY.**

13 There is no manner in which a system could be developed that would guarantee
14 that ratepayers would pay the appropriate amount of income tax. The taxable income for a
15 C corporation is based on the net income from the business. Taxable income for the
16 individual is based on the transfer of income in any number of ways including salaries,
17 interest, dividends, supplemental income, etc. The individual income tax rate will be the
18 same for all of those income sources with no preferential tax treatment for any source in
19 particular. There is no fair way to reconcile the shareholder's personal income tax with a
20 corporate income tax rate that will guarantee that ratepayers will pay an appropriate and
21 fair amount of income tax. As Staff recently acknowledged, about the best we can do is
22 "damage" the ratepayer as little as possible⁷.

23 _____
24 ⁷ See the testimony of Staff's witness, Daryl Carlson in the recent Pima Utilities case. Transcript at 326 – 327.

1 If the Commission changes the policy, RUCO recommends that the tax imputation
2 be based on the actual taxes paid, and not a theoretical tax amount. The Commission
3 itself argued before the Arizona Court of Appeals in the *Consolidated* case that "The issue
4 of taxes that are actually paid dominates in states which have authorized inclusion of
5 income taxes even for entities that do not directly incur income taxes."⁸ The Commission
6 made this argument to show that a theoretical tax allowance would be arbitrary and
7 inappropriate. See attached excerpt of the Commission's Brief in the *Consolidated* case.

8 RUCO would not recommend that the Commission consider basing the imputation
9 on federal and state statutory income tax rates. In reality, the vast majority of individuals
10 pay an effective tax rate after deductions and adjustments. Their effective tax rate in most
11 cases is always below the statutory rate.

12 If the Commission approves the draft policy, RUCO would recommend that the
13 Commission adopt Staff's alternative methodology of imputation in Staff's Supplemental
14 Staff Report dated June 27, 2012.

15
16 **VI. THE CONSTITUTION'S DIRECTIVE TO SET JUST AND REASONABLE RATES
17 PRECLUDES THE INCLUSION OF UTILTIY EXPENSES THAT DO NOT EXIST.**

18 RUCO believes that the Commission is prohibited by the Arizona Constitution from
19 setting rates that include shareholders' personal income tax liability. Neither the S
20 Corporation nor the LLC pays income taxes. Setting rates based on an operating expense
21 that does not exist will not result in just and reasonable rates. The Commission is required
22 to set just and reasonable rates under the Arizona Constitution. Ariz. Const. Art. 15, § 3.

23
24 ⁸ See Appellee Arizona Corporation Commission's Answering Brief at 29-33, *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 875 P.2d 137 Ariz.App. Div. 1, 1993, (September 07, 1993), 1 CA-CC 92-0002. The relevant excerpt of the Answering Brief is attached hereto as Attachment 1.

1 A change in policy will violate Arizona's Constitutional requirement to set just and
2 reasonable rates.

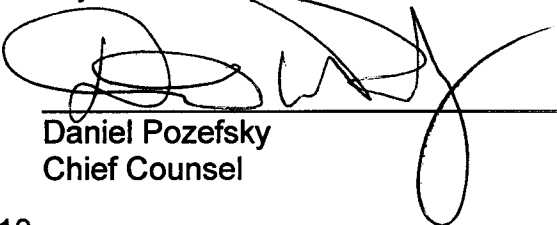
3 The Arizona Court of Appeals, at the Commission's request has upheld the current
4 policy. See *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 484,
5 875 P.2d 137, 143, Ariz.App. Div. 1, 1993 (September 07, 1993). The Arizona Court of
6 Appeals rejected Consolidated's arguments to change the current policy made in the
7 course of several Consolidated cases. *In the Matter of Consolidated Water Utilities*,
8 Docket Nos. E-1009-86-216, E-1009-86-217, E-1009-86-332.) Decision No. 55839
9 (Docketed January 8, 1988). *In the Matter of Consolidated Water Utilities*, Docket Nos. E-
10 1009-90-115, E-1009-90-116 (decision No. 57666 (docketed December 19, 1991).

11 It took more than five years, and many battles for the Commission to settle in on the
12 current policy. The Court of Appeals decision made it clear that Arizona is not bound to
13 follow FERC or any state for that matter on the issue. The Court held that the Commission
14 set just and reasonable rates when it excluded recovery of personal tax expense. The
15 Commission, consistent with its prior decisions as well as the Arizona Court of Appeals
16 decision, should not change the current policy.

17 **VII. CONCLUSION**

18 For these and many other reasons, changing the current policy to allow pass-
19 through entities recovery of income tax that these entities do not pay is bad public policy –
20 period.

21 RESPECTFULLY SUBMITTED this 11th day of February, 2013.

22 
23 Daniel Pozefsky
24 Chief Counsel

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ATTACHMENT

COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

CONSOLIDATED WATER UTILITIES, LTD., a limited partnership,)	1 CA-CC 92-0002
)	
Appellant,)	CC Case No.
)	E-1009-90-115,
v.)	E-1009-90-116
)	
ARIZONA CORPORATION COMMISSION,)	
)	
Appellee.)	

APPELLEE'S ANSWERING BRIEF

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August 24, 1992

imposed what it recognized to be a hypothetical tax based on its understanding that an actual tax was paid, 412 P.2d at 850. The Suburban court notes that Moyston is the only decision of a court of last resort on the issue. After noting that the Public Utility Commission had recently approved the imputation of federal income tax liability for a Subchapter S utility, the Suburban court held "...that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less." 652 S.W.2d at 363, 364 (emphasis added).

The issue of taxes that are actually paid dominates in states which have authorized inclusion of income taxes even for entities that do not directly incur income taxes. While the Suburban case remains valid law in Texas, its effects have been somewhat mitigated. In Southern Union Gas Company v. Railroad Commission of Texas, 701 S.W.2d 277 (Tex.App. 3 Dist. 1985), the Texas Court of Appeals refined the Suburban doctrine somewhat, noting "...the Commission did not abuse its discretion in disallowing "theoretical" income tax liability for rate making purposes." 701 S.W.2d at 279. The Southern Union decision is cited approvingly by the Texas Supreme Court in Public Utility Commission of Texas v. Houston Lighting & Power Company, 748 S.W.2d 439 (Tex. 1987), in which theoretical income tax liability is also disapproved.

The most recent word on the topic of taxes actually paid is found in Kansas and it is particularly apposite in the current situation. In Greeley Gas Co. v. State Corporation Commission, 807

P.2d 167 (Kan.App. 1991), the Kansas Court of Appeals, while noting that Suburban appeared to still be good law in Texas, affirmed the Kansas Corporation Commission's disallowance of income taxes based on the utility's failure to produce the taxpayers income tax returns to demonstrate what income taxes were actually paid, if any, noting that the individual shareholders particular situation could cause the tax rate to vary across the various tax brackets that exist, 807 P.2d at 169, 170. In the current case, the issue of theoretical income taxes is squarely joined. Appellant asserts that their rebuttal evidence before the Commission provided evidence of an actual income tax obligation, Appellant's opening brief at page 39. Appellant also asserts that the witness upon whose testimony the income tax disallowance was based admitted that he would have allowed income taxes had Appellant been a corporation, Appellant's opening brief at page 33, citing TR. 446.

Appellant fails to do at least two things, however. First, appellant fails to provide clear and satisfactory evidence of income tax amounts actually paid. The testimony cited by appellant indicates a calculation of income tax attributable to the operation of the utility. Without evidence of the actual payments made by the partners, no clear and satisfactory showing of unreasonableness of the Commission's order has been made, see Greeley, supra. Secondly, in addition to failing to demonstrate the actual amounts paid, appellant has not addressed the theoretical nature of the calculation of income tax it offered. Appellant mentioned the testimony at page 446 of the transcript on the topic of whether the witness would have allowed income taxes if it had been a corporation. Appellant failed to address the