Telephone Company Deferred Taxes and Investment Tax Credits – A Capital Loss for Ratepayers

By MICHAEL J. MAJOROS, JR.

The article identifies and discusses a capital loss incurred by Bell operating company ratepayers as a result of the divestiture and deregulation of accumulated deferred taxes and unamortized investment tax credits associated with customer premises equipment. It describes the coming confrontation between at least two state commissions, which have required these losses to be flowed back to ratepayers, and the Bell system, which has obtained an Internal Revenue Service ruling that threatens future benefits if the losses are flowed back.

BECAUSE tax laws differ from regulatory accounting rules, a utility's actual tax expense is not prepared by using the same expenses and calculations that are allowed by regulators in the rate-making process. Two major items causing differences between a utility's actual tax expense and the regulatory tax allowance are accelerated depreciation the investment tax credit (ITC). Most utilities (and their regulators) use "tax normalization" to reconcile these differences.

Accumulated Deferred Taxes

Tax normalization requires that during the initial years of an asset's life ratepayers must pay higher taxes reflective of straight-line book depreciation rather than accelerated tax depreciation. Later in the assets life, as the tax and book depreciation relationship reverses itself, the book taxes will be less than the actual taxes. In other words, the actual tax rate on the earnings of an asset is less than the book tax rate early in an asset's life and greater than the book tax rate later in the life. In effect, ratepayers provide an advance to the utility which will later be paid back to them. This payback, or turnaround, begins when the actual tax rate on the earnings of the asset exceeds the book tax rate. Until this turnaround occurs, the tax advance is recognized as a capital contribution and is deducted from rate base for rate-making purposes. Under regulation, when the turnaround of the tax book depreciation difference occurs, the accumulated deferred tax account is depleted and the prior collections are returned to ratepayers. By time the asset has reached its service life, the book tax rate and the actual tax on its *total* earnings should be the same.

This theoretical result is demonstrated in the simple example in Table 1. The example compares revenue requirements under tax normalization and the alternative "flow through" of actual taxes for a $100,000 asset having a five-year useful life and a three-year accelerated cost recovery system (ACRS) life. The example assumes an 11.75 per cent pretax cost of capital, and a constant 46 per cent tax rate. As can be seen, after, the five-year service life the total taxes, and indeed total revenue requirements, are the same under both methods.

Table 2 carriers the example one step further by introducing the rate base reduction of accumulated deferred taxes into the normalized cost of service. This table demonstrates that at the end of the five-year service life the total normalized revenue requirement is less than the flow-through revenue requirement in absolute dollars. However, when the individual yearly revenue requirements are discounted back to their net present cost using the hypothetical company's posttax cost of capital,

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TABLE 1

COMPARISON OF NORMALIZATION AND FLOW-THROUGH
REVENUE REQUIREMENTS

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Total*
Normalization- Cost of Service						
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$100,000
Normalized Tax Allowance	6,559	5,247	3,936	2,624	1,312	19,678
Return	11,750	9,400	7,050	4,700	2,350	35,250
Total	$38,309	$34,647	$30,986	$27,324	$23,662	$154,928
Flow-through Cost of Service						
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$100,000
Flow-through Tax Allowance	2,300	(10,086)	(10,546)	19,661	18,349	19,678
Return	11,750	9,400	7.050	4,700	2,350	35,250
Total	$34,050	$19,314	$16,504	$44,361	$40,699	$154,928
Rate Base	$100,000	$80,000	$60,000	$40,000	$20,000	

Cost of Capital

	Per Cent	*Cost*	*Pretax Weighted Cost*	*Tax Effect*	*Posttax Weighted Cost*
Debt	45	.09	.0405	(.08163)	.02187
Equity	55	.14	.0770	-0-	.07700
Total	100		.1175	(.01863)	.09887

TABLE 2

COMPARISON OF NORMALIZATION AND FLOW-THROUGH
REVENUE REQUIREMENTS REFLECTING RATE BASE
REDUCTION OF ACCUMULATED DEFERRED TAXES

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Total*
Normalization- Cost of Service	$38,309	$34,226	$29,048	$23,955	$21,977	$147,515
Net Present Charges	34,862	28,344	21,892	16,429	13,716	115,243•
Flow-through Cost of Service	34,050	19,314	16,504	44,361	40,699	154,928
Net Present Charges	30,986	15,995	12,438	30,424	25,401	115,244•
Cost of Capital – Posttax = .09887						

• Difference in totals due to rounding.

the amounts are the same under both methods. Once again equality is struck. From a regulatory standpoint the theoretical equality of the two methods supports normalization.

Investment Tax Credits

The theory underlying normalization of investment tax credits is that they should be spread evenly over the generations of ratepayers who use the asset which creates the credits. Rather that reduce book tax expense by the full amount of the ITC in the year it is actually used by the company (as would happen under flow through), the recognition of the ITC is deferred and amortized back into income over the life of the asset. As with accumulated deferred taxes, the presumption is that the company will collect taxes from ratepayers in excess of actual taxes paid early in an asset's life, but it will repay these taxes by the time the asset is retired.

Table 3 is a simple five-year example comparing normalization and flow through of 10 percent investment tax credit. In this example only straight-line depreciation has been used. The example retains the 11.75 per cent pretax cost of capital and constant 46 per cent tax rate used in Tables 1 and 2. Once again, the example shows that total tax costs and consequently revenue requirements are equal under both methods. Over the life of the asset ratepayers are required to pay no more than actual taxes.

Not all of the unamortized ITCs can be deducted from rate base. The Internal Revenue Code allows only deduction of tax credits taken prior to 1971. Those credits were accumulated under various tax provisions from 1962 through 1969.

The Revenue Act of 1971 established what is commonly referred to as the Job Development Investment Tax Credit. This credit was available to utilities under one of two options. The American Telephone and Telegraph Company and the Bell operating companies (BOCs) elected the option which requires

TABLE 3

COMPARISON OF NORMALIZATION AND FLOW-THROUGH
OF INVESTMENT TAX CREDIT

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Total*
Normalization- Cost of Service						
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$100,000.00
Normalized Tax Allowance	2,856	1,544	232	(1,080)	(2,392)	1,160
Return	11,750	9,400	7,050	4,700	2,350	35,250
Total	$34,606.00	$30,944.00	$27,282.00	$23,620	$19,958	$136,410
Flow-through Cost of Service						
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$100,000
Flow-through Tax Allowance	(11,959)	5,247	3,936	2,624	1,312	1,160
Return	11,750	9,400	7,050	4,700	2,350	35,250
Total	$19,791	$34,647	$30,986	$27,324	$23,662	$136,410

that the credit not be included in income – i.e., shown as a reduction in tax expense – more rapidly that ratably over the life of the property, and that the rate base shall not be reduced by any portion of the investment tax credit. Thus, the code precludes a rate base reduction for the credits utilized since 1971.

Effect of Deferring a Dollar of Tax

In order for a utility to collect and retain a dollar of deferred taxes from ratepayers, it is necessary to gross the dollar up to its pretax level. This is because the IRS will consider that dollar to be taxable profit. Thus for federal taxes, the incremental revenue requirement associated with deferring one dollar of tax is $1.85 at the present 46 per cent rate. Through this mechanism, called the tax-on-tax effect, ratepayers are charged amounts even greater than the unpaid taxes included in utilities deferred tax reserves.

Under the theory of normalization, when the turn-around of depreciation timing difference and the amortization of the ITC occurs, there is a reverse tax-on-tax effect. That is, the ratepayers revenue requirements decline 1.85 for every dollar of deferred tax flow back. In theory, ratepayers come out whole. If the deferred taxes or unamortized investment tax credits are not flowed back, however, ratepayers obviously do not come out whole. Instead, they suffer a loss in an amount even greater than the booked deferred taxes and unamortized investment tax credits.

Regulatory Promise

Normalization could not be justified without the implicit promise that the higher taxes initially collected from ratepayers would later be returned to ratepayers. This promise of "flowback" presumes, of course, that the utility's rates will continue to be regulated in a manner which recognizes ratepayers' prior contribution and assures them a "flowback" with the related reverse tax-on-tax effect.

With respect to the assets transferred from BOCs to AT&T Communications, Inc. (AT&T interexchange subsidiary), the implicit promise may be kept. The assets used for intrastate service will continue to be regulated by the state commissions, and the rates charged for their use should reflect the continued recognition of previously collected deferred taxes and unamortized investment tax credits.

Unfortunately, with respect to the embedded customer premises equipment (CPE) assets transferred from BOCs to AT&T Information Systems, Inc. (ATTIS), the implicit promise is not likely to be kept. These assets have passed out of the regulatory purview of the state commissions. For a period of two years, they will be subject to the limited regulation of the Federal Communications Commission. In CC Docket No. 81-893, the FCC has established a "sales Plan," which requires "that the embedded [CPE] base in the aggregate, must be offered for sale at net book value"[1] defined as original cost less the related depreciation reserve plus transaction costs. Thus, it appears that ratepayers will not be compensated for their prior contributions of deferred taxes and investment tax credits with respect to the CPE transferred to ATTIS.

Plan of Reorganization and FCC Detariffing Of Embedded CPE

The Plan of reorganization required that Accounts 176.1, "Accumulated Deferred Taxes – Accelerated Tax Depreciation," be assigned to AT&T in the same proportion that the net book value of the assigned (transferred) plant bore to the total net book value of plant within the vintage rate category.[2] Account 176.2, "Accumulated Deferred Taxes – Other," was assigned using various methods depending on the type of tax and book difference underlying the deferred amounts.[3] The unamortized investment tax credits reflected in a subaccount of 174, "Other

[1] Report and Order, FCC CC Docket No. 81-893, Footnotes 40 and 114, and ¶219

[2] Plan of Reorganization, filed December 16, 1982, by American Telephone and Telegraph Company in the U.S. district court for the District of Columbia, Civil Action No. 82-0192, United States v Western Electric Co., Inc. and American Telephone and Telegraph Co. (p. 167).

[3] Plan of Reorganization, p. 168 (description of various methods).

Deferred Credits" (174.08), were assigned to AT&T based upn the assets transferred.[4]

Apparently, U.S. District Court Judge Harold H. Greene anticipated problems arising from the deregulation of CPE in the broader divestiture scenario. Judge Greene stated in a footnote to his modification of final judgment:

> It is irrelevant to these proceedings that certain assets, such as customer premises equipment, may in the future be removed from public service because of eventual deregulation under FCC's Computer II decision or other regulatory action. *If there will be problems as a result of the retirement of these assets form public service, they would arise at that time as result of regulatory decision; they would not stem from the proposed decree* (552 F Supp 203, Footnote 303.) (Emphasis added.)

In its report and order detariffing CPE, the FCC states that it "originally concluded that the deferred tax reserves should be transferred to ATTIS, but that the unamortized ITCs should remain with the BOCs and be credited to their income tax expense at the time the associated CPE is removed from the regulated accounts."[5]

The FCC subsequently revised its conclusion and determined that both the deferred tax reserves and unamortized investment tax credits associated with embedded CPE should be transferred to ATTIS.[6] The FCC essentially adopted the accounting treatment for taxes relating to the CPE which is described in the plan of reorganization.

The effect of the transfer on the BOCs books is that they received a credit to stockholders' equity which was never recorded as income. The accounting entries for this transaction began with the establishment of subsidiaries to receive the assets from the BOCs. Initially, these subsidiaries were owned by BOCs but their stock was subsequently transferred to AT&T.

The divestiture accounting entries on BOCs' books to establish the subsidiaries were as follows:

Entries	*Debit*	*Credit*
1) Investment in Affiliated Companies - IXC and CPE Subsidiaries (101.1)	$xxx	
2) Depreciation Reserve (171)	xxx	
3) Accumulated Deferred Income Taxes (176.1 and 176.2)	xxx	
4) Other Deferred credits (174)	xxx	
5) Liability Accounts:	xxx	
6) Telephone Plant In Service (100.1)		$xxx
7) Telephone Plant under Construction (100.2)		xxx
8) Property Held for Future Use (100.3)		xxx
9) Other Assets		xxx

The transfer of assets net of liabilities was debited to Account 101.1, "Investment in Affiliated Companies" (entry 1 above). The subsidiary investment account thus contained the value of the transferred asserts net of liabilities *and* net of deferred taxes and unamortized investment tax credits. In other words, the asset transfer was reduced by the amounts.

The final step was the transfer of the subsidiary stock to AT&T. The value of the stock equaled the BOCs' Account 101.1, "Investments in Affiliated Companies." The credit (decrease) resulting from the transfer was debited against Account 181, "Unappropriated Retained Earnings." Thus, the tax-related reduction in the value of the transfer ultimately showed up as an increase in the equity section of the BOC's balance sheet. This can be seen more clearly by isolating the accounting flow of the deferred taxes and unamortized investment tax credits.

To establish CPE subsidiary

	Debit	*Credit*
Accumulated deferred income taxes	$xxx	
Unamortized investment tax credits	xxx	
Investment in affiliated company		$xxx
To transfer subsidiary stock to AT&T		
Investment in affiliated company	$xxx	
Unappropriated retained earnings		$xxx

When collapsed even further the basic deferred tax and unamortized ITC entry on the BOCs' books was:

To establish CPE subsidiary and transfer subsidiary stock to AT&T

	Debit	*Credit*
Accumulated deferred income taxes	$xxx	
Unamortized investment tax credits	xxx	
Unappropriated retained earnings		$xxx

Note that a credit increases retained earnings.

The tax deferrals, previously treated as a contribution from ratepayers, were declared to be equity capital belonging to investors. The ratepayers lost their capital contribution; the stockholders correspondingly gained. The companies enjoyed the original benefit of collecting the higher tax amounts from ratepayers and were then relieved of the requirement to pay them back. Further, the transaction increase the retained earnings account which could subsequently be used to provide working capital to other subsidiaries of the BOCs' new corporate parents.

These amounts would have reduced future tax expenses chargeable to ratepayers with concomitant reversal of the tax-on-tax effect as they were returned to ratepayers. With respect to transfers to ATTCOM it is anticipated that they will continue to do so. However, with respect to the transfer to ATTIS, it is not.

State Commission Action

Two of the state commissions regulating the Mountain States Telephone and Telegraph Company (Mountain Bell) have attempted to recapture these lost deferred taxes and credits for ratepayers in their states. In Docket No. 1032, the New Mexico State Corporation Commission recognized that the tax accounts associated with assets transferred to entities which it no longer regulated had been funded by ratepayers and that with the

[4] Plan of Reorganization, p. 163.
[5] Report and order, FCC Cc Docket No, 81-893, ¶ 143.
[6] Id.

transfer those tax accounts would become equity capital to Mountain Bell. Thus the commission found:[7]

> Mountain Bell's ratepayers will lose the benefit to which they entitled in the income tax deferrals and unamortized investment tax credits unless the following rate-making steps are taken, and the company is directed to take these steps for rate-making purposes:
>
> a) Establishment of separate accounts title "CPE Deferred Taxes Due to Ratepayers" and "CPE Unamortized Investment Tax Credits Due to Ratepayers."
> b) Initial credits to these accounts shall be made in the amounts of the intrastate portion of deferred taxes ($9,633,000) and unamortized tax credits ($2,568,000), respectively.
> c) The accounts shall be amortized over the average remaining lives of the transferred assets (six years), commencing with the 1984 test year.
> d) Intrastate income tax expense for Mountain Bell will be reduced by $1,408,000 and $366,000 for the respective accounts, for a total of $1,774,000, to reflect the first year of amortization.
> e) Mountain Bell's rate base will be reduced by $8,225,000, the net unamortized balance of the "CPE Deferred Taxes Due to Ratepayers" account.

In Idaho Case No. U-1000-70 a similar adjustment was made. In that proceeding the Idaho Public Utilities Commission found:

> The fact is that charges to the ratepayers should have decreased as a result of the election of accelerated depreciation but because of the implementation of normalization, the ratepayers did not see a decrease. They, in fact, have paid more tax expense to the company than the company has had to pay to the federal government. The company readily admits that this is a source of capital to it. The commission tried to maintain a balance of fairness by subtracting the amount of the deferred taxes from rate base so that at least the ratepayers were not required to pay the company a return on ratepayer-provided funds. We find that the ratepayers paid and the company has the use of, and still retains the benefit from money that was to pay tax expense that, in actuality, was not paid.[8]

IRS Ruling

AT&T and the BOCs have counterattacked through the Internal Revenue Service. On May 9, 1983, AT&T on behalf of itseld and its (then) affiliates, requested the IRS to make the following rulings:

> The deferred tax reserve attributable to the transferred assets must be removed from each transferor's books of account and no part of such deferred tax reserve may be used to reduce the transferor's rate base or cost of service (or treated as no-cost capital).
>
> The balance of unamortized investment tax credit (after adjustment of recapture, if any) with respect to the transferred property should be removed from the transferor's books to reflect the assignment of the property and no portion of such unamortized investment tax credit may be used to reduce the transferor's cost of service or rate base under § 46(f)(2).[9]

On Decemver 29, 1983, the IRS issued its response. The two rulings requested by AT&T were adopted virtually word for word:

> The deferred tax reserve attributable to the transferred assets must be removed from each transferor's books of account and no part of such deferred tax reserve may be used to reduce the transferor's rate base or cost of service (or treated as no-cost capital) after the transfer.
>
> The balance of the unamortized investment tax credit (after adjustment for recapture, if any) with respect to the transferred property should be removed from the transferor's books to reflect the assignment of the property and no portion of such unamortized investment tax credit may be used to reduce the transferor's cost of service or rate base under § 46(f)(2) of the code.[10]

Mountain Bell has now seized upon the IRS as a basis for reversing the New Mexico and Idaho decision. In its appeal to the New Mexico supreme court, for example, Mountain Bell states that the: "order requiring Mountain Bell to reimburse its ratepayers for the CPE associated accounts transferred to AT&T is contrary to law and arbitrary and capricious."[11]

One of the specific reasons given by Mountain Bell is: "The commission's treatment of deferred income tax reserves and unamortized investment tax credits jeopardizes Mountain Bell's continued eligibility for accelerated deprecation and investment tax credit."[12]

AT&T and the BOCs have also used the threat of adverse IRS action to persuade the FCC to relinquish its regulatory hold on the lost deferred taxes and tax credits. In its report and order in CC docket No. 81-893 dealing with the detariffing of CPE, the FCC found that:

> there is substantial risk that retention of those accounts by the BOCs (to be used to reduce rates after the associated assets have been removed from the unregulated books)

[7] Final order, New Mexico State Corporation Commission, Docket No. 1032, pp. 17-19.
[8] Idaho Public Utilities Commission, Case No. U-1000-70, Order No. 18872, pp. 3, 34.
[9] Colorado Application No. 1 and S 1655, DOD Exhibit No. 1401.
[10] Id., Mountain Bell Exhibit No. 37.
[11] Mountain Bell brief in chief, p. 11, supreme court of the state of New Mexico, Case No. 15,365.
[12] Id.

would violate the requirements of the Internal Revenue Code (the "code") with serious adverse tax consequences for the BOCs, resulting in financial burdens for those companies and their ratepayers.[13]

The FCC noted that:

[13] Report and order, FCC Docket No. 81-893, ¶ 144.

AT&T has submitted requests for rulings to the IRS on…whether the BOCs could retain the deferred tax reserves and unamortized ITCs associated with the embedded CPE and the use of those reserves or credits to reduce their rate bases or costs of service after the transfer of those assets.[14]

AT&T requested the IRS to rule that the reserves and credits may not be retained – not to determine whether they could be retained.

Conclusion

What appears to be shaping up is something of a regulatory showdown." The capital loss to ratepayers identified by the New Mexico and Idaho commissions is undeniable, but the proposed recovery of that loss may jeopardize the entire structure of tax benefits enjoyed by the BOCs. On the other hand, the IRS ruling, solicited by AT&T,has no precedential value and is subject to modification or revocation pending adoption of temporary or final regulations, or in rate or unusual circumstances. Howe the confrontation resolves itself may be one of the interesting regulatory developments of the coming year.

[14]Id., Appendix A, ¶52.

Profile of the Telephone Industry

This year the nation's 1,454 local telephone companies will spend $18 billion on new construction to expand and improve service. The traditional independent, or non-Bell, telephone companies plant to spend $4.4 billion for plant modernization and expansion, and the divested Bell companies plant capital expenditures of $13.8 billion, according to "PhoneFacts '84," the United States Telephone Association's annual report on the telephone industry.

Total plant investment for all telephone companies will reportedly reach $183 billion this year. Operating revenues are estimated to total $77 billion, making the telephone industry the second largest utility, following electricity.

"PhoneFacts '84," also forecasts a continued move upward in revenues. It notes that rate increases will reflect inflation and the adjustment of rates to match costs of maintaining service in each segment of the industry.

Reported operating cost data indicates that in most typical areas, the cost to the local company to provide basic service is about $28 while customers pay only $12 to $15 per month. More than 30 cents of very dollar charged to toll calls has been helping to pay for the cost of providing local service, according to the associations' study.

This situation is changing in a deregulated environment where prices will more closely reflect actual cost of service, raising local service rates but considerably lowering long-distance rates.

For the consumer there is good news in the widening scope and variety of new services and telephone equipment becoming available. This publication answers some of the most commonly asked questions about the new telephone industry, and its lists the top 125 telephone companies by access lines. A feature article on how to plan phone service to meet individual needs is included.

The nation's "telephone territory" is served by 1,429 independent telephone companies operating in more than half of the United States, while two dozen Bell companies serve the rest. Copies of "PhoneFacts '84" are available by contacting the United States Telephone Association at 1801 K Street, N.W., Suite 1201, Washington, D.C. 20006.