



# Comprehensive Tax Reform Priorities: Excess Deferred Tax Transition Issues

Shareholder-owned electric utilities support the goals of tax reform to simplify the U.S. tax code, broaden the tax base, and reduce rates. Reducing federal income tax rates for heavily regulated shareholder-owned electric utilities, however, will create a number of transition issues that Congress should address in any tax reform legislation.

One of these transition issues is the treatment of so-called excess deferred taxes. Many companies may have excess deferred tax reserves after a federal income tax rate reduction because the change in the law requires a recalculation of deferred tax liabilities. However, unlike other companies that would recognize excess deferred taxes as income, regulated shareholder-owned electric utilities are required to refund excess deferred taxes, related to asset depreciation, to their customers.

Electric utilities support a fair and equitable distribution of excess deferred taxes across their customer base. To meet this goal, any tax reform legislation should include a provision to require state public utility commissions (PUCs) to refund excess deferred taxes, related to asset depreciation, over the remaining lives of the assets being depreciated.

## Understanding Deferred Taxes And Excess Deferred Taxes

A deferred tax liability—or a deferred tax—is the amount of taxes currently saved by a company that will be repaid in the future due to a temporary timing difference between the “book” treatment of an asset on a company’s financial records and the tax treatment based on Internal Revenue Code rules.

The most common example of a deferred tax occurs when a company claims accelerated tax depreciation for an asset. (For an electric utility, an asset could be a power plant or large power transformer, for example.) Accelerated depreciation means that a company will record more depreciation in the first few years of an asset’s life and less depreciation in the later years, relative to book or regulatory depreciation. While this approach results in a timing difference, cumulative tax and book depreciation generally are equal over the course of an asset’s life.

Following is a basic example of how deferred taxes work:

- Assume the tax depreciation of an asset is \$20.00 in the year the asset is placed in service.
- If the book depreciation of the asset is \$10.00 that year, there is a \$10.00 temporary difference between the tax depreciation and the book depreciation.
- The \$10.00 temporary difference creates a current tax savings of \$3.50 (\$10.00 taxed at the current 35 percent federal income tax rate) and a future (deferred) tax liability in the same amount. This future liability is recorded in a reserve on the balance sheet and generally is titled “Accumulated Deferred Income Taxes.”

Excess deferred taxes arise as the result of an income tax rate reduction. If the federal income tax rate is reduced from 35 percent to 25 percent, for example, the amount of deferred taxes that would be needed to

pay the future obligation to the federal government would decrease by approximately 28 percent (10 percent divided by 35 percent).

Using the accelerated depreciation example, the \$3.50 of deferred taxes would be reduced to \$2.50 (\$10.00 of future income taxed at the 25 percent tax rate). For a company with an accumulated deferred income tax liability, the tax rate reduction is equivalent to the federal government reducing a portion of future tax liabilities. This reduction is known as the excess deferred taxes which, in this the example, would be \$1.00 (\$3.50 minus \$2.50).

## How Electric Utilities Manage Excess Deferred Taxes

Because shareholder-owned electric utilities are heavily regulated by state PUCs, these utilities must handle excess deferred taxes differently than other businesses. A state PUC sets the rates that a regulated electric utility may charge its customers for electricity service. The PUC allows the utility to recover its “cost of service” and also gives the utility an opportunity to earn a reasonable rate of return on its invested capital (i.e., its “rate base”). Among the items included in cost of service are fuel costs, operations and maintenance costs, depreciation expense, and income tax expense.

If an electric utility accelerates the depreciation of an asset, the IRS requires utilities to follow specific accounting rules, called normalization, that follow this process:

- Collect the deferred taxes from current customers;
- Use the deferred taxes to reduce the rate base; and
- Return the deferred taxes to future customers.

When a tax rate reduction creates excess deferred taxes, all companies must account for the excess. A non-regulated company generally would recognize the excess deferred taxes as income for financial statement purposes. However, an electric utility must refund the excess deferred taxes to ratepayers, requiring the recording of a regulatory liability.

The challenging issue facing electric utilities is the timing of the payments to customers. Generally, if the excess deferred taxes are returned to the customers immediately, the utility’s cash flow is sharply reduced. In addition, an immediate payment disproportionately benefits current customers—who receive the entire refund—and unfairly penalizes future customers, who pay for the cost of long-lived utility assets over their remaining useful lives and who may not receive any of the refund.

When Congress last reduced corporate tax rates in the Tax Reform Act of 1986, lawmakers resolved this issue by enacting a provision that would require state PUCs to refund the excess deferred taxes related to depreciation over the remaining lives of the assets. Congress should include a similar provision in any tax reform legislation that reduces the federal income tax rate. This would allow all customers who pay for the cost of utility assets over their useful lives to share in the return of the excess deferred taxes.

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