

Florida Public Service Commission
Fletcher Building
101 East Gaines Street
Tallahassee, Florida 32399-0850

M E M O R A N D U M

AUGUST 29, 1991

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING

FROM: DIVISION OF APPEALS (RULE) *WR*
DIVISION OF WATER AND SEWER (MCCASKILL) *CPN*
DIVISION OF AUDITING AND FINANCIAL ANALYSIS (HICKS) *H* *ay* *RH* *780*

SUBJECT: DOCKET NO. 910531-WS - PETITION FOR DECLARATORY STATEMENT RELATED TO APPROPRIATE TREATMENT OF TAXES RELATED TO CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION (CIAC) BY KINGSLEY SERVICE COMPANY IN CLAY COUNTY.

AGENDA: 9/10/91 - CONTROVERSIAL AGENDA - PARTIES MAY NOT PARTICIPATE

PANEL: FULL COMMISSION

CRITICAL DATES: NONE

CASE BACKGROUND

Kingsley Service Company is a Florida water and sewer utility corporation operating in Clay County under Certificates of Public Convenience and Necessity Numbers 44-W and 43-S. The utility has petitioned the Commission for a declaratory statement regarding certain tax treatment of Contributions-in-Aid-of-Construction (CIAC).

On February 13, 1986, the Florida Waterworks Association requested that the Commission investigate a proposed amendment of Section 118(b), Internal Revenue Code (Code), under which certain contributions to the capital of a corporation were excluded from the calculation of federal taxable income or loss. Congress passed the proposed amendment to Section 118(b) of the Code and, effective January 1, 1987, all CIAC received after December 31, 1986 was included in the calculation of taxable income or loss in the year received. In addition, contributed plant became depreciable for federal tax purposes.

By Order No. 16971, issued December 18, 1986, on an emergency basis, this Commission authorized corporate utilities subject to

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its jurisdiction to amend their service availability policies to gross-up CIAC in order to meet the tax impact resulting from the inclusion of CIAC as gross income. On December 31, 1986, Kingsley received tariff approval for gross-up.

In its petition, the utility explains a method by which it attempted to avoid payment of taxes on CIAC. Because the Internal Revenue Code allowed a two year expenditure period for CIAC funds paid prior to December 31, 1986, the utility accepted notes as payment of CIAC in the total amount of \$7,461,721.17. The utility, an accrual basis taxpayer, thus treated the notes as CIAC received in 1986, before CIAC became taxable. According to the utility, \$3,965,489.94 of this amount was collected during 1987 and 1988 for projects completed under the agreements, \$2,238,162.60 was subsequently refunded or the notes were rescinded because the developments never materialized, and the balance of \$1,258,068.63 was either paid after December 31, 1988, or is still on the books.

In its petition, the utility states that it included a provision in its water and sewer agreements which "basically stated that if the payment of the CIAC is not considered as valid payment and the result is that a tax liability is created . . . then the developer is responsible to reimburse the cash impact of that liability to [the utility] to the extent which it is allowed by the Florida Public Service Commission." Recently, the utility's position has been challenged by the Internal Revenue Service, which has assessed the utility taxes in the approximate amount of \$1.5 million, plus penalty and interest. The utility contested the assessment and petitioned the Commission for a declaratory statement regarding aspects of the utility's handling of the tax issue.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission grant Kingsley Service Company's Petition for Declaratory Statement?

RECOMMENDATION: Yes. The petition contains one issue which meets the threshold requirements for a declaratory statement found in

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section 120.565, Florida Statutes and Rule 25-22.021, Florida Administrative Code.

STAFF ANALYSIS: Section 120.565, Florida Statutes, provides that the purpose of a declaratory statement is to "set out the agency's opinion as to the applicability of a specified statutory provision or of any rule or order of the agency as it applies to the petitioner in his particular set of circumstances only." Rule 25-22.021, Florida Administrative Code, which implements the statute, specifies that a declaratory statement is a means for resolving controversy or confusion:

A declaratory statement is a means for resolving a controversy or answering questions or doubts concerning the applicability of any statutory provision, rule or order as it does, or may, apply to petitioner in his or her particular circumstances only. The potential impact upon petitioner's interests must be alleged in order for petitioner to show the existence of a controversy, question or doubt.

The utility requested that the Commission issue a declaratory statement as set forth in Issues 2 - 6 below. Staff believes that most of the questions raised by the utility do not meet the threshold requirements for a declaratory statement, as discussed below, but that one such issue is properly the subject of a declaratory statement. Staff therefore recommends that the Commission grant the utility's petition, although not in favor of every position proposed by the utility.

ISSUE 2: Should the Commission declare that Kingsley Service Company should pursue a contest of any proposed taxation of the CIAC received as notes during December of 1986?

RECOMMENDATION: No.

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STAFF ANALYSIS: There appears to be no controversy, question, or doubt raised by the application of any statutory provision, rule or order which gives rise to this request. In its petition, the utility cites Commission Orders Nos. 16971, 23541 and 23114, which do not appear to raise any questions as applied to the utility. Rather, the utility seeks a determination by the Commission of a matter that falls into the category of management decision-making.

Proposed Agency Action Order No. 16971 was issued on December 18, 1986 in Docket No. 860184-PU (In Re: Request by Florida Waterworks Association for investigation of proposed repeal of Section 118(b), Internal Revenue Code (Contributions in Aid of Construction)). In that order, the Commission granted an application by Florida Waterworks Association to allow water and wastewater utilities to gross-up CIAC in order to recover taxes imposed by the Tax Reform Act of 1986 on formerly nontaxable CIAC.

Kingsley Service Company's petition does not claim, and staff does not believe, that the application of this order gives rise to any controversy, question, or doubt as to whether Kingsley Service Company should pursue a contest of any proposed taxation of the CIAC received as notes during December of 1986. Rather, the utility seeks a predetermination of the prudence or reasonableness of a management decision.

Order No. 23541 was issued in Docket No. 860184-PU on October 1, 1990. The order retained the CIAC gross-up and, among other things, specified accounting procedures and required utilities to file a petition for approval to continue or begin collecting the gross-up. The order also contains a discussion on avoidance of taxes on CIAC at page 4, which concludes: "Accordingly, we hereby encourage the water and wastewater industry to continue to search for viable methods" to avoid taxes on CIAC. (Reconsideration of this order was denied and clarification was granted in Order No. 24413, issued on April 22, 1991. However, the clarification does not affect this issue.) Kingsley Service Company's petition does not claim, and staff does not believe, that the application of Order No. 23541 gives rise to any controversy, question, or doubt as to whether Kingsley Service Company should pursue a contest of a tax assessment of the CIAC received as notes during December of 1986. The utility has not alleged that this order has any possible impact upon its interests which gives rise to a proper petition for

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declaratory statement. Instead, the decision whether or not to contest proposed taxes is the type of management decision which the utility is best suited to make. Such decisions are typically reviewed by the Commission at a later date rather than pre-approved in a declaratory statement:

Generally, we do not insert ourselves into the day-to-day decision-making processes of a utility. In fact, we normally do not review the management decisions of a utility unless it has applied for a rate increase or we have initiated an overearnings investigation.

(Order No. 23541 at 9)

Order No. 23114 was issued in Docket No. 891316-WS (In Re: Application of Kingsley Service Company in Clay County for approval to increase service availability charges, pay taxes on CIAC rather than pass them on to developer, and approve inclusion of its investment in income taxes in rate base) on June 25, 1990. The Commission granted the utility's amended petition to reduce its CIAC gross-up percentage and for authorization to include net prepaid CIAC taxes in rate base. Again, this order has no impact upon the utility's management decision on whether or not to contest proposed taxes.

In its petition, which the utility was given ample opportunity to amend, the utility states that, in developing its note-as-payment of CIAC procedure, it "gave much research and thought to ways to legally avoid and/or defer the effect of the loss of the nontaxable status of C.I.A.C.", and that "[s]uch attempts at avoidance or deferral were informally encouraged by the Commission and its Staff from the initiation of Commission Docket No. 860184-PU, and in fact encouragement was specifically enumerated in Order No. 23541." (petition at 3) The petition also states that "[t]he Commission's interpretation of its Orders does affect the Company in its particular set of circumstances, in that the Company will have to make decisions" related to the tax issues discussed in its petition. However, the petition fails to point to any provision in the orders cited which impacts its interests with regard to contesting taxes. With regard to Issue 2, the petition does not meet the threshold requirements for a declaratory statement. Staff

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recommends that the Commission decline to issue the declaratory statement requested by the utility.

ISSUE 3: Should the Commission declare that costs of contesting taxation of CIAC received as notes during December, 1986 should be capitalized as intangible plant by Kingsley Service Company?

RECOMMENDATION: No.

STAFF ANALYSIS: Nothing in the orders cited by the utility impact this decision. The utility has shown no controversy, question or doubt arising from the cited orders as to whether it should capitalize the as yet unascertained costs of contesting taxation of CIAC. Therefore, the petition does not meet the threshold requirements for a declaratory statement. For the reasons discussed in Issue 2, staff recommends that the Commission decline to issue the declaratory statement requested by the utility.

ISSUE 4: Should the Commission declare that, to the extent the IRS ultimately prevails on its position that the CIAC received as notes during December, 1986 is taxable to the Kingsley Service Company, the utility should pursue collection of such tax from the appropriate developers in accordance with its rights under the notes executed with the developers, to the extent utility management determines that such pursuit has a reasonable likelihood of success, based upon the likelihood of collection, the amount to be collected, and the cost of collection?

RECOMMENDATION: No.

STAFF ANALYSIS: The utility seeks Commission pre-approval for a series of management decisions the utility must make. Nothing in the orders cited by the utility impact this decision. The utility has shown no controversy, question or doubt arising from the cited orders as to whether and to what extent it should pursue collection

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of taxes from developers. Therefore, the petition does not meet the threshold requirements for a declaratory statement. For the reasons discussed in Issue 2, staff recommends that the Commission decline to issue the declaratory statement requested by the utility.

ISSUE 5: Should the Commission declare that the gross-up percentage to be utilized in determining the amount of monies owed to Kingsley Service Company by developers in the event the IRS ultimately prevails with regard to its proposed taxation of the CIAC notes should be based upon the gross-up percentage in effect at the time the IRS determines that such CIAC was received?

RECOMMENDATION: Yes.

STAFF ANALYSIS: Order No. 16971 allowed utilities to gross-up in order to recover taxes on formerly untaxable CIAC. The order was issued on December 18, 1986. Pursuant to that order, Kingsley Service Company received tariff approval of a service availability policy which included a CIAC gross-up of 59.566 percent for CIAC collected after December 31, 1986. On June 25, 1990, by the terms of Order No. 23114, the utility received permission to decrease the gross-up to 25.17 percent.

According to the petition, the utility included a provision in its water and sewer agreements with developers which specified that if payment of CIAC notes resulted in a tax liability for the utility, the developer must reimburse the utility for the cash impact of the liability to the extent allowed by the Commission. The utility seeks a determination of the appropriate percentage to use in actions to collect CIAC gross-up from developers.

If the utility collects CIAC gross-up from developers, it will receive the funds while the decreased (25.17 percent) gross-up is in effect. However, the IRS treated the CIAC as taxable income received by the utility when collected from developers. Kingsley collected most, if not all, of the CIAC which gives rise to the tax liability between December 31, 1986 and June 25, 1990, when the

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59.566 percent gross-up rate was in effect. Therefore, Staff recommends that the Commission issue a declaratory statement that the tariff approved pursuant to Order No. 16971 contains the appropriate gross-up percentage for CIAC which the IRS deems to have been collected during the time the tariff was in effect.

ISSUE 6: Should the Commission declare that in the event it is concluded by the utility's legal counsel and management that taxes cannot reasonably and economically be recovered from developers, the utility should be allowed rate base treatment with regard to such amounts of income tax for which the utility is liable as a result of the IRS action?

RECOMMENDATION: No.

STAFF ANALYSIS: The rate base treatment requested by the utility rests upon a management decision. That is, the utility seeks rate base treatment of an unspecified amount "in the event it is concluded" that the funds in question "cannot reasonably and economically be recovered". The issue of rate base treatment is therefore premature. The decision whether it is reasonable and economical to pursue collection of the funds is inappropriate for a declaratory statement. Nothing in the orders cited by the utility impacts these decisions.

There is no conflict or controversy as to whether CIAC debit deferred taxes, once offset against credit deferred taxes, may be properly included in rate base. This has been the policy of the Commission, and is clearly set forth in Order No. 23514 and in the clarification of that order (Order No. 24413). Additionally, in Order No. 23114, Kingsley Service Company was granted permission to record net CIAC debit deferred taxes in rate base. The utility has cited no conflicting order, rule or statutory provision giving rise to uncertainty on its part. Therefore, it appears that this is actually another way of asking about the prudence of the decision to pursue reimbursement from developers. The Commission should decline to issue a declaratory statement which would have the effect of pre-approving the reasonableness or prudence of the

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utility's collection efforts. According to the terms of Order No. 23114, the utility may record net CIAC debit deferred taxes in rate base. However, amounts included in rate base pursuant to the terms of Order No. 23114 will remain subject to Commission scrutiny, as always.

ISSUE 7: Should this docket be closed?

RECOMMENDATION: Yes.

STAFF ANALYSIS: In declaratory statement proceedings the Commission may close the docket upon issuance of the order.

/MR
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Dear **Mr. Avery:** _____ DATE **4/30/91** _____

RE: Docket No. **910531-WS** _____

This will acknowledge receipt of **petition for declaratory statement related to appropriate treatment of taxes related to contributions-in-aid-of-construction (CIAC) by KINGSLEY SERVICE COMPANY in Clay County.**

which has been filed as of this date. Appropriate staff members will be advised.

STEVE TRIBBLE, Clerk BY: **lcw** _____