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Homer E. Sayad

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Liberalized Depreciation

By Homer E. Sayad
Partner, Saint Louis Office

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In December 1957 the *Electrical World* asserted that one of the ten most difficult problems facing utility company management in 1958 was what to do about liberalized depreciation. It said: "Some utilities see liberalized depreciation as beneficial to them and their customers. But some utilities, considering rulings or the thinking of regulatory bodies, decide not to use liberalized depreciation."

This is not a new problem nor is it an old one. I am sure that most of you have wrestled with it, probably vigorously, in one way or another, since 1954 when the new Internal Revenue Code was enacted. I shall not therefore review the provisions of Section 167 of the Code which made possible the adoption of a depreciation method that accelerates the deductions in accordance with the double declining-balance method, the sum-of-the-years-digits method, or other similar methods meeting certain tests. Instead, I shall review the current regulatory status of this matter and shall comment on certain implications of recent developments.

TAX DEFERRAL

Liberalized depreciation as it relates to a single asset results in no permanent deferral of income tax obligations. It simply changes the timing of the deduction. In the early years the deduction is greater than on a straight-line basis and in later years it is smaller. When the depreciable plant as a whole is considered, however, an interesting result may occur because of the mixture of depreciation deductions. Again, thinking of the plant as a whole, in the early years the fast depreciation amount will exceed the straight-line amount. But there will come a time, if fast depreciation is applied to each year's additions, when as to older property straight-line depreciation will exceed fast depreciation and as to newer property the reverse will be true. The combined effect, if there is growth, is that the depreciation deduction based on a liberalized method will continue to exceed the deduction based on the straight-line method. Accordingly, in these circumstances, the period during which additional working capital is being generated by liberalized depreciation may not be followed by a period when additional funds will be required to meet tax obligations. It is this feature of liberalized depreciation that has brought about certain regulatory developments unlike those applying to amortization of the cost of emergency facilities.

ASSUMPTIONS FOR PERMANENT DEFERRAL

Of course, there are important assumptions that have to be made to reach the conclusion that there is a permanent deferral of income taxes. It must be assumed that the same or increasingly larger expenditures for property additions or replacements will be made each year and that the tax structure and rates will remain substantially unchanged. Uncertainties as to these factors are not unimportant.

ATTITUDES OF REGULATORY BODIES, ACCOUNTING ORDERS

The views that regulatory bodies may take concerning these matters are, of course, particularly important. They also affect the accounting that may be appropriate in the circumstances.

A number of state commissions have ruled on the accounting in connection with liberalized depreciation. Generally, in accounting rulings there has been a disposition to permit a charge to income for an amount equivalent to the tax reduction resulting from liberalized depreciation as compared with straight-line depreciation which is continued in the accounts. This is the basis that was commonly adopted earlier in connection with the amortization of the certified cost of emergency facilities. The effect is to show the same net income that would have been shown if the straight-line method had been used for tax purposes. Thus, the procedure is frequently referred to as the "tax normalization" method or as "deferred tax accounting."

The commissions have approved various treatments of the amount offsetting the additional provision for income taxes; some have approved showing it in a tax reserve, that is, as a liability, others have approved showing it as restricted surplus, and at least one has approved handling the amount through the reserve for depreciation.

The order here in Massachusetts calling for tax normalization by a credit to a tax reserve is representative of a large number of accounting orders.

A few orders have approved the "flow through" method which is simply a situation in which no recognition is given to the tax differential—the tax reduction stays in or "flows through" to net income. The provision for taxes is the amount payable for the year as shown in the return; the net income shown in the accounts during the early years of the use of liberalized depreciation is greater than it would have been if straight-line depreciation had been deducted for tax purposes.

Some of the commissions have been explicit in their accounting orders that the findings do not bind the commissions in connection with rate proceedings. The West Virginia commission, for example, in approving tax normalization for accounting purposes said: " . . . . the approval granted herein does not bind this Commission as to any matter involved herein in any rate proceeding or any other proceeding before this Commission . . . ."

The Public Service Commission of Missouri having recognized and authorized the accounting for deferred income taxes proceeded to say, however, that the accounting procedures outlined are "for accounting purposes only, and the establishment of said accounting procedures shall not be, and shall not be deemed to be, controlling for rate making purposes . . . ."

It seems to me to be rather fruitless for a commission to issue orders dealing with accounting for deferred taxes if they do not intend to allow a charge to income for such taxes for rate making purposes. I rather doubt that many utilities will be interested in taking accelerated depreciation if the regulatory commissions will not allow them to defer the resulting tax reduction. The use of accelerated or liberalized depreciation imposes certain accounting and administrative burdens. A utility company will not voluntarily and readily subject itself to these added burdens without being allowed to reap the benefits as well.

FEDERAL POWER COMMISSION

In 1956 the Federal Power Commission issued an order in the case of Amere Gas Utilities Company, et al, that approved deferred tax accounting for natural gas companies. The Commission weighed what it considered to be Congressional intent in connection with liberalized depreciation when it said: "It is clear that the charging of greater depreciation during the early life of property and the charging of less during the later life operates to create a deferral of income taxes. The fact that there may be continuing additions to plant, year by year, with the result that there will be a balance in the reserve account at all times in the foreseeable future, does not prove that there is no tax deferral. On the contrary, it proves that there is a continuing tax deferral so long as additional facilities are being installed. This is precisely what Congress intended . . . .

We cannot strike down an Act of Congress if we think it unwise, or unnecessary to a particular industry, and enforce it only if it is in accord with our economic and regulatory philosophy. It is undisputed that Section 167 of the Internal Revenue Code does apply, and was intended to apply to regulated natural gas companies, such as the petitioners."

Early in 1957 the Commission issued a notice of proposed rule-making which, in effect, would codify the orders in connection with accelerated amortization and liberalized depreciation relating to natural gas companies as well as a notice proposing to apply similar rules to electric utilities reporting to it. In addition, an account was proposed for income tax deferrals relating to other differences between the tax return and the accounts.

The Commission requested comments and heard arguments in September last year in connection with the proposed rules. The proposed rules provide that companies that follow "deferred tax accounting" use a tax reserve account for the deferral. A considerable part of the arguments heard by the Commission concerned the matter of whether the rules should also permit the tax deferral to be shown as restricted surplus.

My firm submitted a letter to the Commission in connection with the proposed rules suggesting that the accounting prescribed or authorized by state and local commissions be permitted and that the credit be permitted to be shown in segregated earned surplus where state regulatory authority has permitted this.

The proposed rules by the Commission would not make it mandatory upon a utility to account on its books for deferred income taxes. This feature of the proposed rules was strongly criticised by one of the witnesses before the Commission and the Commission was urged that the setting up of a reserve for deferred income taxes be made mandatory wherever a utility adopted and used one of the methods of accelerated depreciation for tax purposes.

This seems to me to be an unreasonable request which does not take into account the rate making considerations so important to a public utility. The revenues of a utility are based on and derived from the rates which the utility charges to its customers. Those rates generally are set by regulatory authorities. The regulatory commissions generally set rates on basis of cost of service. If the Commission allows for rate purposes and as allowable cost only the amount of actual taxes paid, whether the taxes are computed on the straight-line or the accelerated depreciation basis, then the resulting revenues should not be charged with the deferred taxes. The deferred taxes of today will become the actual taxes paid in a future year. They should be charged to income and allowed as expense in that year.

RATE-MAKING ORDERS

Among the states (nine that I know about) that have issued orders in rate proceedings more have rejected deferred tax accounting than have accepted it.

The Pennsylvania commission rejected tax normalization saying, in part: "Considering this issue in the light of the foregoing comments and conclusions, we hold that accelerated tax depreciation does in fact permit utilities to reduce income taxes and reduce their actual cost of service over an indefinite but extended period of years . . . . We, therefore, reject respondent's claim and will allow income taxes which reflect the tax effect of accelerated tax depreciation."

These views were upheld by the Pennsylvania Superior Court which stated, in part: "It is also argued for the utility, with questionable consistency, that the tax liability is merely deferred when accelerated depreciation is taken; and that the amounts saved in the early years should be placed in a reserve to pay future taxes. In considering this approach the commission noted that whether there is or is not an actual tax saving or deferral depends upon the amount of new plant construction in 1954 and future years; and that, assuming the utility will add no additional plant after the test year, its actual tax liability relating to property presently being depreciated under the accelerated method will not be higher than under the straight-line method for the next seventeen years. Even under this extreme theoretical assumption it is impossible to say at this time what the taxes for this utility will be seventeen years from now."

The New Jersey commission has ruled against tax normalization in a rate proceeding involving a water company, and thus limited the income tax expense to the actual tax paid for the year. The Missouri commission also has ruled against tax deferral accounting in a rate case involving a water company.

Last year the New Hampshire commission in rate proceedings rescinded an earlier accounting order calling for deferred tax accounting. In doing so it stated: "It was originally assumed that these tax savings (from accelerated depreciation) would be of a temporary nature, and they would be exhausted in later years. It is now the considered opinion of utility accountants, and many regulatory commissions, that in the case of a growing and expanding utility, such tax savings will be continuous so long as the growth continues."

The Maine commission similarly in a rate case reversed a previous accounting order that called for tax normalization. It discussed the matter of expansion of plant and uncertainties as to the course of income tax rates in the future and concluded: "Altogether we are convinced that the weight of the evidence in this case . . . together with the highest available judicial precedent, demonstrates that the company should use as expenses only the actual taxes which it pays in the field of accelerated depreciation." I understand that the Maine Supreme Court has upheld this view.

The California commission in rate proceedings rejected a company proposal to take advantage of liberalized depreciation and to normalize income taxes in connection with it. The commission noted that the "applicant has not yet made its election for the test year, but it is apparent from the record that it will not elect to take accelerated depreciation if taxes are allowed in this decision only on an estimated 'as paid' basis. In arriving at the proper allowance for tax expense we shall, therefore, calculate applicant's tax expense, so far as the Section 167 options are concerned, on the basis of straight-line depreciation. Should applicant, despite this decision, elect to claim accelerated depreciation in its tax returns for the test year or any future year before a final decision is rendered by the commission on this issue, it shall immediately report such election to the commission; and the commission will promptly move to adjust the rates herein authorized in such manner as it may find to be appropriate." Actually, therefore, the commission neither accepted deferred tax accounting nor rejected it.

The Oklahoma and Indiana commissions, on the other hand, have approved deferred tax accounting. They have permitted income taxes to be normalized for rate purposes as well as accounting purposes. The Indiana Public Service Commission also approved such accounting for rate purposes in the Indiana Public Service Company case and the Commission was later upheld by a county court.

Last October the Kentucky commission approved the normalizing of taxes for accounting and rate purposes in the income statement, but held that the resulting reserve for income taxes should be deducted from the rate base because these amounts are available for corporate purposes, including construction, for some years to come.

In Connecticut, as I understand it, the commission has stated that its prescribed classification of accounts does not permit recognition of the tax deferral. The commission has held hearings in connection with a request for approval of deferred tax accounting for rate purposes, but has not acted upon the request. This matter was taken to the Connecticut commission by The Housatonic Public Service Company which has put forth much effort to gain approval of income tax deferrals for both accounting and rate purposes. Hearings were held on this matter last July and again in September. Mr. Bacon informs me that the commission has ruled that the Company may take depreciation on the straight-line basis and that if it elects to take accelerated depreciation the tax saving should be allowed to flow through to the customers.

It is clear that the matter has not yet shaken down as far as regulation, and particularly rate-making, is concerned.

FACTORS TO CONSIDER

Some of your companies, if not all of them, have probably made their decisions as to adoption of a fast depreciation method; a few may not have. Some may be re-examining their decisions.

There is no standard formula that can be applied to all companies in resolving this matter, not even to all companies coming under the jurisdiction of the same regulatory body. Among the factors that will require weighing by each company are the following:

The views of the regulatory bodies to which it reports.

The situation as to rates and the likelihood of a change in them.

The level of earnings currently and the probable level in the future.

Growth potential, particularly as to annual rates.

Current Federal income tax matters. If, for example, double declining-balance is adopted, will there be Treasury Department resistance to a rate twice the one that has been accepted by the Department in the past in connection with straight-line depreciation? Will adoption of a fast depreciation method provoke review by the Internal Revenue Service of various matters previously accepted by it? Not too many companies have been examined by the Service for 1954. Thus, it is probably too early to draw other than speculative conclusions as to what the import of this factor may be.

The change in accounting records that may be required.

The possibility of criticism on the ground of lack of prudence in not adopting a fast depreciation method. Stockholders, customers, and even regulatory bodies may contend that material benefits have been lost by management's failure to avail the company of the additional working capital equivalent to the tax reduction. A regulatory body conceivably could take the view that for rate-making purposes the allowance for income taxes should be limited to the taxes that could have been paid.

The likelihood of a change in the income tax laws, including the possibility of repeal of the provisions concerning liberalized depreciation.

FINANCIAL STATEMENT CONSIDERATIONS

In addition to the regulatory aspects of liberalized depreciation, matters relating to its impact on financial statements generally have been talked and written about at length. Mainly the discussion has been in two veins, assuming in both cases that a fast depreciation method is used for tax purposes and that the straight-line method is used in the accounts. One, whether income should be charged, for a fair presentation of the results of operations, with an amount equivalent to the tax reduction in connection with liberalized depreciation. And two, whether the balance sheet should show a liability, that is, a deferred credit or a reserve, for taxes to be paid in the future or whether the offsetting credit may be shown as restricted surplus. As a matter of practice, more companies are charging income with an additional amount equivalent to the tax reduction than are not and more of those that are doing so are showing the tax deferral in a reserve than in restricted surplus.

In October 1954 the committee on accounting procedure of the American Institute of Certified Public Accountants issued *Accounting Research Bulletin No. 44*. In it the committee expressed the view that "in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income until a relatively few years later, and then only if the amounts are clearly material." Later, "in the ordinary situation" was interpreted as possibly excluding public utilities where the regulatory considerations were especially significant.

The committee presently has under consideration a revision of Bulletin 44 that would call for deferral of taxes in all situations where the tax effect of different depreciation methods in the accounts and the tax return is material. The revision now is in the hands of various groups, including representatives of public utilities, that have been asked to comment on it.

An interesting diversity of views as to the purpose of tax deferral accounting exists in some quarters. Generally, in the United States the view is that provision is being made for income taxes payable in the future. In some Canadian circles the view is espoused that it is an accounting for the current tax reduction. According to the latter view, it does not matter what might happen to income taxes in the future; the important thing is that there is a current reduction to be deferred and taken back into income when the depreciation charges in the books exceed those shown in the tax returns.

I think that for accounting purposes generally—and purely for accounting purposes—it is sound reporting to defer income taxes in connection with liberalized depreciation when the effect on income is material. Similarly, for accounting purposes generally, I think it preferable to show the related credit for the tax deferral either as a deferred credit or as a reserve.

I stated earlier that rate-making considerations are paramount in the case of a public utility. Income for financial statement purposes is essentially a matter of matching revenues and related expenses. This is especially so in enterprises such as gas and electric utility companies whose revenues depend on rates authorized or permitted by the numerous commissions having jurisdiction over rates and accounting. Thus, the attitude that a regulatory body takes in connection with tax deferrals and rates is important in effecting a matching of revenues and related expenses—the essential process in income determination. Similarly important, for financial statement purposes, is the attitude of the regulatory authority about the balance-sheet treatment of the related credit as a reserve or as restricted earned surplus.

CONCLUSION

As mentioned previously, the attitudes that the commissions have taken or are going to take in connection with fast depreciation and rates are particularly important. Many have not spoken. Some are saying, in effect, that Congress did not intend a permanent deferral of income taxes in connection with rapid depreciation and that, accordingly, the present customer should benefit from the tax reduction. Others are saying that only by normalizing taxes can the Congressional intent be achieved; that, otherwise, the additional working capital will not be available for reinvestment.

Out of the welter of views that prevail I think one thing is particularly important. In a situation where the commission has said that rates are to be based on the actual taxes payable for the year and, in doing so, has ordered a rate decrease, or has disallowed an increase otherwise warranted, it is important that a record be built to support a higher rate that may be requested in the future when the tax obligation may increase because of liberalized depreciation. The membership of commissions may change and, accordingly, their philosophies may change. It would be well, therefore, to have the record show that disallowance of a provision for taxes equivalent to the current tax reduction may require allowance of a larger amount for taxes in the future.