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April 14, 2015

The Honorable John R. Thune
The Honorable Benjamin L. Cardin
Co-Chairs
Business Income Tax Working Group
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Submission to Business Income Tax Working Group Regarding Need for Excess Deferred Income Tax Transition Rule

Dear Senators Thune and Cardin:

American Electric Power (AEP) welcomes this opportunity to provide input to the Business Income Tax Working Group. Our submission is intended to be helpful to the Finance Committee in its efforts to draft fundamental corporate income tax reform legislation.

AEP supports the goal of U.S. corporate income tax reform. The 35% corporate tax rate is among the highest in the world. We believe that reducing the corporate tax rate would promote economic growth in the U.S. by stimulating capital investment and employment and making American companies more competitive internationally.

We would like to call the Working Group's attention to a transition issue that is particularly important to AEP and other regulated utility companies with respect to tax reform that reduces the corporate tax rate. That is the issue of normalization of excess deferred taxes.

Allow us to briefly explain what excess deferred taxes are and how they result from corporate tax rate reductions. Deferred taxes arise largely from the use of accelerated tax depreciation under the Modified Accelerated Cost Recovery System (MACRS) on depreciable property used in business. Regulated utilities use MACRS, but there are special provisions, called normalization rules, applicable only to regulated utilities, requiring that the tax benefit of accelerated depreciation must be spread over the life of the assets in setting utility rates charged to customers. Congress first enacted the normalization rules in 1969 because it was concerned that if state regulatory commissions required the tax benefits of accelerated depreciation to be immediately flowed through rates to current customers, regulated utilities would not have the intended tax incentive to increase capital investments.

Regulated utilities normalize the tax benefits of accelerated depreciation by recording a deferred tax on the difference between tax depreciation and the book depreciation that is allowed for ratemaking purposes, and amortizing the deferred tax over the useful life of the assets. The

accumulated deferred tax balances on the books of regulated utilities represent taxes to be paid in the future, when the book/tax timing differences reverse; that is, as assets become fully depreciated for tax purposes through accelerated depreciation, while book depreciation continues through the useful life of the assets.

The accumulated deferred taxes have been recorded at the current corporate income tax rate of 35%. If the corporate tax rate is lowered, the taxes to be paid in the future will be paid at the lower rate. Thus, a portion of the accumulated deferred tax balance would be "excess deferred tax."

Regulated utilities should and must flow these excess deferred taxes back to customers. But the transitional issue that regulated utilities would face is the timing of returning excess deferred taxes to customers. If utilities are required to flow excess deferred taxes to customers immediately or too rapidly, the utilities' cash flow would be suddenly and sharply reduced. This would make it difficult for utilities to maintain capital spending for the upkeep and improvement of their utility production, transmission and distribution systems, and would necessitate increased borrowing. Moreover, immediate flow-through of excess deferred taxes would disproportionately benefit current utility customers at the expense of future customers who would continue to pay for the cost of the utility assets over their remaining useful lives.

In order to avoid the difficulty of too-rapid flow-through of excess deferred taxes, tax reform legislation should include a transition rule similar to that enacted in the Tax Reform Act of 1986[1] - the last time the corporate tax rate was reduced - that would require spreading the return of excess deferred taxes to customers over the remaining useful lives of the assets.

In the event corporate tax reform legislation eliminates accelerated tax depreciation, the transitional rule should include an added provision. Under section 203(e) of the Tax Reform Act of 1986, the penalty for violating the requirement to normalize excess deferred taxes was the denial of the use of accelerated depreciation thereafter. If accelerated tax depreciation is eliminated, that penalty would no longer be effective. In the event of elimination of accelerated depreciation, the new transitional rule should include a requirement that any excess deferred tax amount that a regulatory commission attempts to flow back too quickly should be immediately paid back to the U.S. Treasury.

The comprehensive tax reform discussion draft released by the House Ways and Means Committee on February 14, 2014 included such a transition rule.[2] A copy of section 3104(g) of the Ways and Means Committee Discussion Draft is attached. This transition rule was included at the urging of the Edison Electric Institute on behalf of its members, including AEP.

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[1] Section 203(e) of the Tax Reform Act of 1986, P. L. 99-514, Oct. 22, 1986, 100 Stat. 2085.
[2] Section 3104(g) of the Discussion Draft Tax Reform Act of 2014 released by the House Ways and Means Committee, February 14, 2014, at pp. 347 – 350.

Paragraph 1 and subparagraph 3(B) of section 3104(g) are identical to the corresponding provisions of section 203(e) of the 1986 Act. Paragraph 2 and subparagraph 3(C) were added to incorporate the provisions of Internal Revenue Service Revenue Procedure 88-12.[3] The definition of "Excess Tax Reserve" in subparagraph 3(A) has been updated to incorporate references to currently applicable sections of the Internal Revenue Code.

Paragraph 4 of section 3104(g) of the House Ways and Means Committee Discussion Draft adds the new penalty provision required if accelerated depreciation is eliminated as part of tax reform.

Technical Correction of Effective Date Provision

The effective date provision in section 3104(h) of the House Ways and Means Discussion Draft provides simply that the amendments in section 3104 "shall apply to property placed in service after December 31, 2016." However, the excess deferred tax normalization transition rule in 3104(g) must apply to all property in service as of the date the corporate tax reduction goes into effect. AEP recommends the effective date provision be revised as follows:

> (h) EFFECTIVE DATE.—
> (1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to property placed in service after December 31, 2016.
> (2) SUBSECTION (g).—The provisions of subsection (g) shall take effect on the date of enactment of this Act.

AEP commends the Finance Committee for undertaking the vital and necessary task of corporate tax reform, and for soliciting public input to the Working Groups. If there are any questions that you would like us to address or if any additional information is required in connection with our submission, please do not hesitate to contact us.

Sincerely,

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[3] 1988-1 C.B. 637, January 1988.