NJUA
NEW JERSEY UTILITIES ASSOCIATION
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September 4, 2013

VIA HAND DELIVERY AND E-MAIL
Board of Public Utilities
Kristi Izzo, Secretary
44 South Clinton Avenue
9th Floor
P.O. Box 350
Trenton, NJ 08625-0350

Re: ***In the Matter of the Board's Review of the Applicability and Calculation of a Consolidated Tax Adjustment, Docket No. EO12121072***

Dear Ms. Izzo,

The natural gas, electric, water and wastewater utilities listed in footnote 1 that are members ("Companies") of the New Jersey Utilities Association ("NJUA")[1] jointly provide this response to the "Notice of Opportunity to Provide Additional Information" dated July 25, 2013 in the above referenced docket. An additional ten copies of this letter are enclosed. An electronic copy of these comments has also been provided to rule.comments@bpu.state.nj.us.

The Companies appreciate the New Jersey Board of Public Utilities' ("Board") thorough examination of this issue and this additional opportunity to comment. We look forward to working directly with the Board and its Staff on this matter.

Many of the companies represented by NJUA will provide responses individually to the questions posed in the July 25, 2013 Notice. However, NJUA would like to utilize this opportunity to provide additional information that will be helpful to the Board as it considers "whether the Board should utilize the CTA," as the question was posed in the original Notice dated March 6, 2013.

As a threshold issue, NJUA reiterates its fundamental position that the Board should not utilize a Consolidated Tax Adjustment (CTA) in rate setting proceedings; rather the Board's policy should be to develop a reasonable tax expense in a rate case. We remain concerned that the current approach in New Jersey can result in very large adjustments that appear to have little or no relationship to the actual current and future tax situation of the utility,

[1] The NJUA members participating in this submission are: Aqua New Jersey, Inc., Atlantic City Electric Company, Pivotal Utility Holdings, Inc. d/b/a Elizabethtown Gas, Jersey Central Power & Light Company, New Jersey Natural Gas, Public Service Electric & Gas Company, South Jersey Gas Company, Atlantic City Sewerage Company, New Jersey American Water, and United Water. Many of these Companies also are providing individual responses to these questions. The Companies reserve the right to assert arguments separately in this proceeding; by joining in this filing such Companies do not waive their rights to file additional material and participate individually in this proceeding.

may result in unintended consequences and negative impacts on utility credit quality and cost of capital, and may impact the attractiveness of New Jersey utilities to investors.

We hope the Board will consider NJUA a resource to assist in gathering information about the vast preponderance of jurisdictions that do not impose a CTA, or where the CTA has been recently rescinded.

To that end, please find the attached version of NJUA's CTA White Paper, which has been updated in a number of ways. It now includes the fact that Texas has revised its law to repeal its CTA for electric utilities. It includes additional information regarding the CTA mechanism that was employed and then subsequently repealed in Oregon. We have also included information we gathered regarding Virginia, where a 2007 law was adopted that precluded use of the CTA and required a stand-alone methodology to be utilized in the ratemaking process.

This leaves only New Jersey, Pennsylvania, and West Virginia where comprehensive CTA's are applied on a systematic basis. In the White Paper, NJUA cites numerous public utility commission decisions from across the country where commission policy has rejected the application of a CTA. We stand ready to provide any of those decisions or relevant background information as the Board may request to facilitate discussions or its own research.

In addition, in order to help develop a full record we have provided additional information for the Board to consider, including the following:

NJUA has attached an "Interagency Policy Statement" from the Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve; Federal Deposit Insurance Corporation; and Office of Thrift Supervision which requires that "[r]egardless of the method used to settle intercorporate income tax obligations, when depository institution members prepare regulatory reports, they must provide for current and deferred income taxes in amounts that would be reflected as if the institution had filed on a separate entity basis."[2] NJUA has also attached a circular from the New York State Department of Financial Services indicating that a domestic tax insurer may calculate its tax liability for regulatory purposes in "...the amount that the domestic insurer would have paid or received if it had filed on a separate return basis with the Internal Revenue Service."[3] These documents are instructive in showing how the use of consolidated taxes by other types of regulated industries is handled by government regulators.

NJUA believes it is important that the Board consider the opinion of the financial community, as we remain concerned that the CTA may have a negative impact on utility cost of capital and attractiveness to investors, thereby possibly impeding utility ability to access needed capital. As a representative comment from one analyst notes:

> "In our view, the CTA similarly ranks as one of the more troublesome determinations for utility investors that can be imposed by regulators ... the use of non-utility tax benefits to reduce utility rates is a direct co-mingling of utility and non-utility operations, and as many utilities are ring-fenced in some fashion from affiliate operations, a CTA could be considered a direct violation of the ring-fencing provisions. Second, a CTA, by its nature, is applied asymmetrically – the commission captures for ratepayers the tax benefits generated by non-regulated operating losses, but certainly does not require utility rates to reflect the tax liabilities of non-regulated affiliates when those affiliates generate a profit. And third, a CTA will reduce the utility's probability of earning its allowed rate of return, because the level of revenue authorized for recovery of the

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[2] (63 FR 64757, 11/23/98).

[3] New York State Department of Financial Services, Circular Letter No. 33 (1979), pg. 2.

utility's income tax expense is below the actual income tax expense reflected in the utility's income statement."[4]

Again, we offer this additional information with the hope it will help the Board to develop a full record. The participating NJUA companies believe this record will demonstrate that the CTA does not comport with sound regulatory practice or the policies of the vast majority of regulatory jurisdictions around the country. We look forward to the opportunity to sit down with the involved parties for a thorough discussion of this issue.

Sincerely,

Andrew D. Hendry
President and CEO

Enclosure

[4] Regulatory Research Associates, *Consolidated Tax Adjustments (a.k.a. Regulatory Confiscation?)*, Topical Special Report, September 12, 2012, pp. 1-2. Included with permission of Regulatory Research Associates.

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Consolidated Tax Adjustments

Background Paper

New Jersey Utilities Association

Introduction

The New Jersey Board of Public Utilities (the Board or BPU) has instituted a generic proceeding to review whether consolidated tax adjustments (CTAs) are appropriate for setting utility rates. Existing Board policy concerning application of a CTA was first implemented in 1992.[1] Although the New Jersey Utilities Association opposes the use of a CTA in setting utility rates, this paper provides information on the application of a CTA in other jurisdictions across the United States. As demonstrated, the CTA is not utilized in the vast majority of jurisdictions and, in recent years, has been explicitly rejected in a number of jurisdictions in which it has been considered. In addition, this paper has been updated to reflect a recent change in one of the limited jurisdictions that has applied a comprehensive CTA, Texas. As explained below, effective September 1, 2013, application of the CTA in Texas is now statutorily precluded with respect to electric utilities. Additional information is also provided about the treatment of CTAs in Oregon and Virginia.

As a general rule, every corporation subject to the federal income tax must report their tax liability on a separate return. However, Section 1501 of the Internal Revenue Code permits an affiliated group of corporations to elect to report its tax liability on a single, consolidated return. Utilities are no different from other businesses in this respect. By filing a consolidated tax return, a utility's parent company may offset the income of some members of the consolidated group with the losses of other members. However, filing a consolidated tax return requires compliance with a complex set of regulations, and election to file such a return is somewhat permanent in nature (i.e., absent IRS consent to discontinue filing consolidated returns, the group must continue to file a consolidated return even if doing so turns out to be disadvantageous relative to filing separate returns).

CTA Defined

The CTA is a regulatory concept in which the federal income tax expense of a regulated utility that is set during a base rate case is reduced by a portion of the tax benefits generated by a non-regulated affiliate's tax losses. A CTA seizes a portion of the tax benefits generated by non-regulated affiliate companies and appropriates those benefits to the ratepayers of the regulated utility. There are also situations where the use of a consolidated tax return results in higher federal income taxes paid than if the filing had been done on a "stand-alone" basis.

[1] *In re the Petition of Rockland Electric Company for Approval of Changes in Electric Rates, Its Tariff for Electric Service, Its Depreciation Rates, and for Other Relief*, BPU Docket No. ER02100724 (Order dated April 20, 2004), *In re the Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service, Phase II*, Docket No. ER90091090J, (Order dated October 20, 1992).

However, NJUA is unaware of any regulatory commission symmetrically applying the CTA for ratemaking when the result is a higher tax expense, and therefore, higher rates, for the regulated utility.

Where else are CTAs utilized?

The Board's policy with regard to CTAs is not reflective of the vast majority of regulatory agencies in this country. Given that Texas passed legislation in June of 2013 to preclude CTAs for electric utilities[2], we are aware of only three remaining states where comprehensive CTAs[3] are applied on a systematic basis: New Jersey, Pennsylvania, and West Virginia[4].

Thus, 50 regulatory jurisdictions (including the Federal Energy Regulatory Commission (FERC), the District of Columbia, and the New Orleans City Council) do not subscribe to the imposition of comprehensive CTAs.

NJUA is aware of two states where a more limited adjustment for consolidated taxes, the "parent interest adjustment," is utilized – Indiana and Florida.[5] This methodology will be described in greater detail later in this paper.

Oregon previously imposed comprehensive CTAs systematically pursuant to a 2005 statute, but on May 24, 2011, the Oregon Legislature enacted legislation that repealed the 2005 statutory requirement.[6] Since the repeal, it is our understanding that CTAs have not been employed in Oregon. The 2005 statute implemented a "true-up" methodology between the amount of all income taxes collected through rates and actual income taxes paid by the utility or its parent company, for the state's four largest electric and natural gas utilities.[7] One of the original proponents of the law, the Citizens' Utility Board of Oregon, noted that ultimately the true-up process "was time-consuming, cumbersome, and resulted in some wacky outcomes..." They noted that "...if we look simply at the sum total of refunds and surcharges, the results [of the true-up] for customers were actually negative..."[8] This was an important factor in the repeal of the 2005 statutory requirement.

In 2005, the Virginia State Corporation Commission ("Virginia SCC") reported that it "has generally adopted a stand-alone policy for the determination of income taxes for ratemaking purposes...However, there have been

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[2] On June 14, 2013, Governor Perry signed SB1364/HB711, which effective September 1, 2013 will preclude application of a CTA for electric utilities. In addition, under Texas' "Gas Utility Regulatory Act," or "GURA", gas utilities are regulated by the Texas Railroad Commission (TRC), not the Texas Public Utility Commission. Under Section 104.055 of GURA, the TRC is precluded from imposing a CTA on the gas utilities under its jurisdiction. See Tex. Utilities Code Ann. Sec. 101.001 et seq. Finally, we are not aware of the application of a CTA for water utilities in Texas.

[3] A comprehensive CTA is one that considers the tax benefits produced by all members of the consolidated group rather than those produced by only selected members.

[4] *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 561, 493 A.2d 653 (1985); *Monongahela Power*, Case No. 06-0960-E-42T (December 5, 2008).

[5] See Florida Commission rule 25-14.004; See Re Muncie Water Works Company, Cause No. 34571, Indiana Public Service Commission, 44 PUR 4th 331 (1981).

[6] ORS 727.210.

[7] Oregon Public Utility Commission Staff, *Oregon PUC Survey of Income Tax Treatment for Ratemaking* January/February 2005, pg. 2 (available at http://www.naruc.org/Publications/Section%208-Oregon-Income%20Tax%20Survey%202005.doc).

[8] Oregoncub.org/news/posts/2011-legislative-session and oregoncub.org/news/reports/cub-supports-utility-tax-law-reform

several cases where savings generated from the filing of consolidated returns have been recognized."[9] Yet, in 2007, Virginia law was modified to clarify that use of a CTA is precluded and stand-alone methodology has to be utilized in utility rate making.[10]

Recent CTA Activity

In addition to the explicit rejection of a CTA by the states of Texas and Virginia referenced above, the CTA has been rejected by regulatory entities in several jurisdictions. In the 30 months prior to the filing of Rebuttal Testimony in the Atlantic City Electric Company base rate case proceeding in May 2012 (BPU Docket No. ER11080469), at least four final orders were issued by state regulators specifically *rejecting* the use of CTAs. These include orders issued by the Public Service Commission of Maryland,[11] the District of Columbia Public Service Commission,[12] the Kentucky Public Service Commission (KPSC),[13] and the Nebraska Public Service Commission.[14] In addition, in May of 2012, the Washington Utilities & Transportation Commission expressly rejected a proposed CTA.[15] In Docket No. E-002/GR-05-1428 (Northern States Power), issued on September 1, 2006, the Minnesota Public Utilities Commission rejected the use of CTAs. The New Mexico Public Regulation Commission rejected the use of CTAs in Case #07-00077-UT (Public Service of New Mexico), issued on April 25, 2008. In fact, the last time a CTA was affirmatively adopted was in early 2007 by West Virginia.[16]

Three of the Commissions referenced above that have recently rejected the use of CTAs cite the rarity of its application in regulatory jurisdictions as a primary rationale for their rejection of CTAs. In a December 2009 order, the Public Service Commission of Maryland stated that, in order to adopt the CTA recommended within that proceeding by Commission staff, the Commission would have to "depart substantially from prior Commission decisions and join a *very small minority* of commissions."[17] In a later case, the Public Service Commission of the District of Columbia based its rationale for rejecting the CTA upon, among other factors,

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[9] Oregon Public Utility Commission Staff, *Oregon PUC Survey of Income Tax Treatment for Ratemaking* January/February 2005, pg. 4 (available at http://www.naruc.org/Publications/Section%208-Oregon-Income%20Tax%20Survey%202005.doc).

[10] Specifically, subsection A. of Va. Code § 56-235.2 provides, in relevant part, that "[f]or ratemaking purposes, the Commission shall determine the federal and state income tax costs for investor-owned water, gas, or electric utility that is part of a publicly-traded, consolidated group as follows: (i) such utility's apportioned state income tax costs shall be calculated according to the applicable statutory rate, as if the utility had not filed a consolidated return with its affiliates, and (ii) such utility's federal income tax costs shall be calculated according to the applicable federal income tax rate and shall exclude any consolidated tax liability or benefit adjustments originating from any taxable income or loss of its affiliates."

[11] *Delmarva Power and Light Company,* Order No. 83085 (December 30, 2009).

[12] *Potomac Electric Power Company*, Formal Case No. 1076 (March 2, 2010).

[13] *Kentucky-American Water Company,* Case No. 2010-00036 (December 14, 2010). Note that in a 2005 order, the KPSC had imposed a CTA on Kentucky-American Water in Case No. 2004-00103. However, in two subsequent cases, Kentucky Utilities – Case No. 2009-00548, and Louisville Gas & Electric – Case No. 2009-00549, the KPSC affirmatively rejected CTAs and the KPSC rejected the imposition of a CTA on Kentucky-American Water in the more recent (2010) case cited above.

[14] *Source Gas Distribution*, Application No. NG-0060 (March 9, 2010).

[15] *Puget Sound Energy, Inc.*, Docket UE-111048/UG-111049 (May 7, 2012).

[16] *Rebuttal Testimony of James I. Warren, IMO Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service Pursuant to NJSA 48:2-21 and NJSA 48:2-21.1 and for Other Appropriate Relief* (May 23, 2012).

[17] *Delmarva Power and Light Company*, Order No. 83085 (pg. 10) (December 30, 2009) (emphasis added).

"well settled ratemaking practices, practices and reasoning of the FERC ... [in addition to] the *overwhelming majority of other state commissions*."[18] In a December 2010 rate case where the KPSC denied utilization of a CTA, it was asserted that the KPSC's policy is to "consistently" reject proposals to apply a CTA and instead to treat utilities on a stand-alone basis. The KPSC's adoption of this policy is based on the KPSC's finding that use of a CTA "would result in the subsidization of ratepayers by non-regulated utility operations" and "[m]oreover" because "*many*" jurisdictions "disfavor" its application.[19]

Other regulators that have considered and rejected the CTA have pointed to its incompatibility with standard rate making practices, familiar principles of utility law, and ratepayer interests. In 2006, the Minnesota Public Utilities Commission (MPUC) rejected the CTA on multiple grounds and held that its rejection was consistent with cost- and benefit-allocation principles applied in previous orders in which it consistently rejected the CTA. Those principles, asserted the MPUC, were adopted, not only in recognition of utility burdens, but also to protect ratepayers from the risks associated with utility diversification into unregulated enterprises.[20] In 2008, in a New Mexico Public Regulation Commission (NMPRC) order rejecting a CTA, the NMPRC cited the treatise, Accounting for Public Utilities, by Robert L. Hahne and Gregory E. Aliff (a widely accepted and authoritative source on utility accounting), which explains that the stand-alone approach is "[t]he only approach that is consistent with *standard ratemaking principles*."[21] The NMPRC determined that the stand-alone method is proper because it "serves the public interest by being consistent with and promoting the accounting and regulatory principles of cost causation, the benefits/burden equation, and prevention of cross subsidization."[22] Notably, NMPRC also cited the apparent "weight of state authority" in its determination to reject a CTA.[23] In its rejection of a CTA as part of a 2010 order, the Nebraska Public Service Commission found that, for any future rate cases, estimating the taxable income "the Company would report if it filed federal income taxes on its own ... is the most reasonable way of determining the appropriate federal tax expense."[24]

More recently, in a May 2012 order rejecting a CTA, the Washington Utilities and Transportation Commission (WUTC), which has repeatedly rejected proposed consolidated tax adjustments, cited a prior order in which it held that utilization of a CTA would violate the "*familiar principle in utility law*" that financial benefits should only follow the burden of risks.[25] The WUTC referenced its adoption of ring-fencing provisions in its rejection of a CTA, noting the protection offered by the ring fence for utility customers: "...after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for

[18] *Potomac Electric Power Company*, Formal Case No. 1076 (order on reconsideration, p. 16) (June 23, 2010) (emphasis added).

[19] *Kentucky-American Water Company*, Case No. 2010-00036 (December 14, 2010). The KPSC noted that a prior approval of the CTA in 2005 was an exception to its policy of consistently rejecting a CTA and that application in that case had involved "unique circumstances" concerning approvals and specific benefits associated with a merger. See *Id.* at 56 (emphasis added).

[20] *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-05-1428 (pps. 25-26) (September 1, 2006).

[21] *Public Service of New Mexico*, Case No. 07-00077-UT (Recommended Decision of the Hearing Examiner, p. 129) (March 6, 2008) (Final Order issued April 25, 2008).

[22] *Id.* at 131.

[23] *Id.* at 128.

[24] *Source Gas Distribution*, Application No. NG-0060, at p. 15.

[25] *Puget Sound Energy*, Docket 111048/UG-111049, Order 08 at 69 (May 7, 2012) (emphasis added).

customers the cost and tax benefits of that financing ... If the *risks and costs* of activities at the parent-level are borne *exclusively* by shareholders – *because customers are insulated from them by the ring fence* – then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities."[26]

It is also worth noting that, after having employed CTAs for a number of years, in 1983, FERC switched to a "benefits follow burdens" (*i.e.*, a non-CTA) approach (Opinion No. 173).[27] Like the state jurisdictions referenced above, FERC rejected the CTA, abandoning its application for the stand-alone approach. In its opinion rejecting the CTA, *Re Columbia Gulf Transmission Co.,* 23 FERC 61,396, Opinion 173 (1983), FERC based its stand-alone approach primarily upon a "benefits follow burdens" analysis which was repeatedly referenced in that opinion.[28]

What CTA methodologies are used?

Of the three states that systematically impose comprehensive CTAs, only New Jersey utilizes a cumulative "time value"-based methodology (prior to its statutory prohibition of CTA, Texas had also utilized such a methodology for electric utilities). In each case, the theoretical tax benefit is the same: the cumulative amount of taxes saved by using tax losses in consolidation that would not have been able to be used absent consolidation. In New Jersey, the CTA is applied in such a way that the CTA rate "penalty" equals the portion of the theoretical tax benefit allocable to the utility multiplied by its weighted overall pre-tax cost of capital. Under the now prohibited Texas methodology, the "penalty" was equivalent to the portion of the theoretical tax benefit allocable to the utility multiplied by the utility's weighted long term debt rate.[29] Given that a utility's weighted overall pre-tax cost of capital is higher than its weighted long term debt rate, New Jersey's methodology results in a distinctly more punitive CTA than did Texas's methodology. In addition, Texas capped its "look back" at fifteen years based upon the fact that, under federal tax law, pre-1998 net operating losses can only be carried forward fifteen years.[30]

The remaining two states that systematically impose comprehensive CTAs, West Virginia and Pennsylvania,[31] utilize a "cost of service" methodology. During the rate making process, instead of computing the current portion of tax expense based on the tax liability the utility would owe as a stand-alone entity, regulators reduce that expense based on the tax losses produced by other members of the consolidated tax group. A rolling historical average over a number of years (such as 3 or 5) is utilized to derive the benefit by which tax expense for the test period is reduced. Unlike the New Jersey and Texas methodologies, the cost of service CTA is not cumulative so that it is only the tax results during the averaging period that impact rates.

As noted above, Indiana and Florida use a "parent interest adjustment". Under this methodology, if the parent company of a utility receives a tax benefit for deducting interest on debt and the parent and the utility file as

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[26] *Id. citing WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 285 (April 17, 2006) (emphasis added).
[27] *Re Columbia Gulf Transmission Co.*, 23 FERC 61,396, Opinion 173 (1983).
[28] *See, e.g.*, 23 FERC at 61,851, 61, 861-62.
[29] *Central Light and Power* (Second Order on Rehearing) (pps. 107-08 and 111-13 and Conclusion of Law 38).
[30] *CPL v. Public Utility Com'n of Texas*, 36 S.W.3d 547, 555 (Tex. App. Austin-2000).
[31] See *Monongahela Power*, Case No. 06-0960-E-42T (pps. 7-8) (December 5, 2008); See generally *Barasch*, 507 Pa. 561, 493 A.2d 653.

part of a consolidated tax return group, then an allocable portion of the tax benefit of the parent's interest deduction is applied to reduce the utility's tax expense for ratemaking purposes.

History of the CTA in New Jersey

Since the inception of the CTA in New Jersey in 1952, the Board has applied several different methodologies for calculating a CTA, including, *inter alia*, the "imputed interest" methodology,[32] and the "chronic loss" approach,[33] both of which utilize a "cost of service" adjustment applicable to a utility's income statement. As noted in the introduction of this paper, existing Board policy in the calculation of a CTA, which is to utilize a "rate base" approach, was first implemented in 1992.

During the years 1986 through 1991, due to significant uncertainty with respect to the IRS's policy toward CTAs, the Board did not utilize a CTA in utility rate cases.

Summary

New Jersey is one of a very limited number of regulatory jurisdictions (3 of 53) that currently utilizes a comprehensive CTA. Of the few jurisdictions utilizing a comprehensive CTA, the Board's approach is one of the most onerous.

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[32] See *I/M/O The Revision of Rates Filed by New Jersey Water Company Increasing Rates For Water and Sewer Service*, BPU Docket No. 7412-915 (Decision and Order January 8, 1976) and *In re Monmouth Consolidated Water Co.*, P.U.R.4th 464, BPU Docket No. 776-481 (April 27, 1978).

[33] See *In re Lambertville Water Co.*, Docket Nos. 746-481, 754-244 (September 11, 1981).

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 98–17]

FEDERAL RESERVE SYSTEM

[Docket No. R–1022]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket No. 98–93]

Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Notice of interagency policy statement.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are adopting a uniform interagency policy statement regarding intercompany tax allocation agreements for banking organizations and savings associations (institutions) that file an income tax return as members of a consolidated group. The intent of this interagency policy statement is to provide guidance to institutions regarding the allocation and payment of taxes among a holding company and its depository institution subsidiaries. In general, intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer. This policy statement is the result of the Agencies' ongoing effort to implement section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), which requires the Agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies.

DATES: This interagency policy statement is effective November 23, 1998.

FOR FURTHER INFORMATION CONTACT: *OCC:* Gene Green, Deputy Chief Accountant, (202/874–4933), or Tom Rees, Senior Accountant, (202/874–5411), Office of the Chief Accountant, Core Policy Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Charles Holm, Manager, (202/452–3502), or Arthur Lindo, Supervisory Financial Analyst, (202/452–2695), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452–3544).

FDIC: For supervisory issues, Robert F. Storch, Chief, (202/898–8906), or Carol L. Liquori, Examination Specialist, (202/898–7289), Accounting Section, Division of Supervision; for legal issues, Jamey Basham, Counsel, (202/898–7265), Legal Division, FDIC, 550 17th Street, NW, Washington, DC 20429.

OTS: Timothy J. Stier, Chief Accountant, (202/906–5699), or Christine Smith, Capital and Accounting Policy Analyst, (202/906–5740), Accounting Policy Division, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

Section 303(a)(3) of the of the CDRI Act directs the Agencies, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, to work jointly to make uniform regulations and guidelines implementing common statutory or supervisory policies. Section 303(a)(1) of the CDRI Act also requires the Agencies to review their regulations and written policies and to streamline those regulations where possible.

In 1978, the FDIC, the OCC, and the Board each published a separate policy statement regarding the allocation and payment of income taxes by depository institutions which are members of a group filing a consolidated income tax return. The OTS provides supervisory guidance on this subject in its Holding Company Handbook. As part of the ongoing effort to fulfill the section 303 mandate, the Agencies have reviewed, both internally and on an interagency basis, the present policy statements and the supervisory guidance that has developed over the years. As a result of this review, the Agencies identified minor inconsistencies in the policy statements and supervisory guidance. Although largely limited to differences in language and not to the substance of the policies and guidelines themselves, the Agencies determined that it would be beneficial to adopt a uniform interagency policy statement regarding intercorporate tax allocation in a holding company structure.

II. Policy Statement

This interagency policy statement reiterates and clarifies the position the Agencies will take as they carry out their supervisory responsibilities for institutions regarding the allocation and payment of income taxes by institutions that are members of a group filing a consolidated return. The interagency policy statement reaffirms that intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity. Accordingly, tax remittances from a subsidiary institution to its parent for its current tax expense should not exceed the amount the institution would have paid had it filed separately. The payments by the subsidiary to the parent generally should not be made before the subsidiary would have been obligated to pay the taxing authority had it filed as a separate entity. Similarly, an institution incurring a tax loss should receive a refund from its parent. The refund should be in an amount no less than the amount the institution would have received as a separate entity, regardless of whether the consolidated group is receiving a refund. However, adjustments for statutory tax considerations which may arise in a consolidated return are permitted as long as the adjustments are made on a basis that is equitable and consistently applied among the holding company affiliates. Regardless of the method used to settle intercorporate income tax obligations, when depository institution members prepare regulatory reports, they must provide for current and deferred income taxes in amounts that would be reflected as if the institution had filed on a separate entity basis.

An institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to its parent since these are not liabilities required to be paid in the current reporting period. Similarly, transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. This is because a parent cannot relieve its subsidiary of this potential future obligation to the taxing authorities, since these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

Finally, the Agencies recommend that financial institution members of a consolidated group have a written, comprehensive tax allocation agreement to address intercorporate tax policies and procedures.

This interagency policy statement revises and replaces the Board's "Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks," (43 FR 22782, May 26, 1978); the OCC's "Statement of Policy on Income Tax Remittance to Holding Company Affiliates," (Banking Circular No. 105, May 22, 1978); the FDIC's Statement of Policy on "Income Tax Remittance by Banks to Holding Company Affiliates" (43 FR 22241, May 24, 1978); and the OTS's "OTS Tax-Sharing Policy," (Section 500, "Funds Distribution," OTS Holding Companies Handbook). This interagency policy statement does not materially change any of the guidance previously issued by any of the Agencies.

The text of the interagency policy statement follows:

Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision ("the Agencies") are issuing this policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its depository institution subsidiaries will often file a consolidated group income tax return. However, each depository institution is viewed as, and reports as, a separate legal and accounting entity for regulatory purposes. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed on a separate entity basis.[1] Furthermore, the amount and timing of payments or refunds should be no less favorable to the subsidiary than if it were a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action.

Tax Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax allocation agreements usually address certain issues common to consolidated groups. Therefore, such an agreement should:

- Require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate entity basis;
- Discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
- Discuss reimbursements to an institution when it has a loss for tax purposes; and
- Prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the Reports of Condition and Income, and other guidance issued by the Agencies require depository institutions to provide for their current tax liability or benefit. Institutions also must provide for deferred income taxes resulting from any temporary differences and tax carryforwards.

When the depository institution members of a consolidated group prepare separate regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate entity basis, regardless of the consolidated group's tax paying or refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., Sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[2] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

Tax Refunds From the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the refund amount it is due on a separate entity basis. Provided the

[1] Throughout this policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

[2] These restrictions include the Prompt Corrective Action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR part 325, subpart B; for national banks, 12 CFR 6.6; for savings associations, 12 CFR part 565; and for state member banks, 12 CFR 208.45.

institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carryback benefits available on a separate entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carryforward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[3] Accordingly, an organization's tax allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

Income Tax Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because the parent cannot legally relieve the subsidiary of a potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

[3] See 26 CFR 1.1502-77(a).

Dated: October 14, 1998.

Julie L. Williams,

Acting Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, October 29, 1998.

Jennifer J. Johnson,

Secretary of the Board.

By order of the Board of Directors.

Dated at Washington, DC, this 5th day of November, 1998.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: October 14, 1998.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

[FR Doc. 98-31179 Filed 11-20-98; 8:45 am]

BILLING CODE 4810-13-P, 6210-01-P, 6714-01-P, 6720-01-P

DEPARTMENT OF THE TREASURY

Customs Service

Proposed Collection; Comment Request; Lay Order Period—General Order Merchandise

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork and respondent burden, Customs invites the general public and other Federal agencies to comment on an information collection requirement concerning Lay Order Period—General Order Merchandise. This request for comment is being made pursuant to the Paperwork Reduction Act of 1995 (Pub. L. 104-13; 44 U.S.C. 3505(c)(2)).

DATES: Written comments should be received on or before January 22, 1999, to be assured of consideration.

ADDRESS: Direct all written comments to U.S. Customs Service, Information Services Group, Attn.: J. Edgar Nichols, 1300 Pennsylvania Avenue, NW, Room 3.2C, Washington, DC 20229.

FOR FURTHER INFORMATION CONTACT: Requests for additional information should be directed to U.S. Customs Service, Attn.: J. Edgar Nichols, 1300 Pennsylvania Avenue NW, Room 3.2C, Washington, DC 20229, Tel. (202) 927-1426.

SUPPLEMENTARY INFORMATION: Customs invites the general public and other Federal agencies to comment on proposed and/or continuing information collections pursuant to the Paperwork Reduction Act of 1995 (Pub. L. 104-13; 44 U.S.C. 3505(c)(2)). The comments should address: (1) Whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (b) the accuracy of the agency's estimates of the burden of the collection of information; (c) ways to enhance the quality, utility, and clarity of the information to be collected; (d) ways to minimize the burden including the use of automated collection techniques or the use of other forms of information technology; and (e) estimates of capital or start-up costs and costs of operations, maintenance, and purchase of services to provide information. The comments that are submitted will be summarized and included in the Customs request for Office of Management and Budget (OMB) approval. All comments will become a matter of public record. In this document Customs is soliciting comments concerning the following information collection:

Title: Lay Order Period—General Order Merchandise Cost Submissions.

OMB Number: 1515-0220.

Form Number: N/A.

Abstract: This collection is required to ensure that the operator of an arriving carrier, or transfer agent shall notify a bonded warehouse proprietor of the presence of merchandise that has remained at the place of arrival or unlading without entry beyond the time period provided for by regulation.

Current Actions: There are no changes to the information collection. This submission is being submitted to extend the expiration date.

Type of Review: Extension (without change).

Affected Public: Businesses, Individuals, Institutions.

Estimated Number of Respondents: 300.

Estimated Time Per Respondent: 15 hours.

Estimated Total Annual Burden Hours: 7,500.

Estimated Total Annualized Cost to the Public: N/A.

Dated: November 16, 1998.

J. Edgar Nichols,

Team Leader, Information Services Group.

[FR Doc. 98-31237 Filed 11-20-98; 8:45 am]

BILLING CODE 4820-02-P

December 20, 1979

SUBJECT: INSURANCE

Circular Letter No. 33 (1979)

TO: ALL DOMESTIC INSURERS

SUBJECT: TAX ALLOCATION AGREEMENTS

It has come to the attention of the Insurance Department that many domestic insurers are entering into tax allocation agreements with their parent corporations, other companies in their holding company system and/or their subsidiaries. Income taxes paid based on consolidated tax returns and intercorporate income tax allocations are transactions between related parties and as such the agreement must be fair and equitable and recognize the separate operating identity of the domestic insurer. This would be consistent with various sections of the Insurance Law, namely, Sections 46-a, 69-e, 69-g and 85-a. In addition, many insurers not subject to the above Sections of the Law have given commitments to this Department which in essence contain similar requirements. These commitments were obtained in order to assure fair and equitable intercompany transactions.

The Department has reviewed several methods currently being used in determining payments under consolidated federal corporate income tax allocation agreements and has developed the attached guidelines to assist domestic insurers in maintaining their fiscal integrity. It is the opinion of this Department that tax allocation agreements must meet the principles contained in these guidelines to be fair and equitable, and to give appropriate recognition to the separate operating identity of the insurer. Any tax allocation agreements involving a domestic insurer presently in existence should be amended to comply with these guidelines.

Pursuant to the provisions of Section 27 of the insurance Law every domestic insurer is directed to notify this Department within 60 days of this circular letter if it participates in a consolidated tax return and to submit a copy of its tax allocation agreement with such notification. Any domestic insurer which currently does not participate in a consolidated tax return shall file a copy of its tax allocation agreement with this Department within 30 days of electing to do so. Furthermore, notification to this Department should be given within 30 days of any amendment to or termination of a tax allocation agreement.

GUIDELINES FOR TAX ALLOCATION AGREEMENTS BETWEEN DOMESTIC INSURERS AND THEIR AFFILIATED COMPANIES

1. Every domestic insurer which is a party to a consolidated federal income tax filing must have a definitive written agreement, approved by its Board of Directors, governing its participation therein.

2. The ultimate holding corporation, any intermediate corporation which owns a controlling interest in the stock of the domestic insurer and the domestic insurer itself must be parties to, but need not necessarily participate in, the consolidated federal income tax agreement. In the case of an alien owned domestic insurer, the ultimate United States Corporation, in whose behalf the consolidated corporate federal income tax return is filed with the Internal Revenue Service, may be

substituted for the ultimate holding corporation.

3. The domestic insurer must calculate its tax liability under method (A), (3) or (C) below. Once a method is elected it should not be changed without 30 days prior notification to this Department.

(A) The tax charge or tax refund to the domestic insurer under the agreement shall be the amount that the domestic insurer would have paid or received if it had filed on a separate return basis with the Internal Revenue Service.

To help assure the domestic insurer's enforceable right to recoup federal income taxes in the event of future net losses an escrow account consisting of assets eligible as an investment for the domestic insurer shall be established and maintained by the parent in an amount equal to the excess of the amount paid by the domestic insurer to the parent for federal income taxes over the actual payment made by the parent to the Internal Revenue Service.

Escrow assets may be released to the parent from the escrow account at such time as the permissible period for loss carrybacks has elapsed.

(B) The tax charge to the domestic insurer under the agreement shall not be more than it would have paid if it had filed on a separate return basis. The domestic insurer shall be "paid" for any foreign tax credits, investments credits, losses or any loss carry over (collectively herein referred to as credits) generated by it, to the extent actually used in the consolidated return. Payment shall be equal to the "savings" generated by its credits. All payments shall be recorded on the domestic insurer's books as contributed surplus.

If the amount paid by the domestic insurer to the parent for federal income taxes is greater than the actual payment made by the parent to the Internal Revenue Service then the difference shall be placed in escrow in the same manner and under the same conditions as in (A) above.

Once an insurer is "paid" for its credits it cannot use such credits in the calculation of its tax liability under the separate return basis. Any of the insurer's credits which are not used in the consolidated return and for which it has not been paid shall be retained by the domestic insurer for possible future use.

(C) Any other method of calculating the domestic insurer's tax liability which provides:

(i) That the tax charge to the domestic insurer shall not be more than it would have paid if it had filed on a separate return basis,

(ii) That payments to the domestic insurer give appropriate recognition to the separate operating identity of the insurer, and

(iii) for a method, such as the use of an escrow account as described in (A) above, to help assure the domestic insurer's enforceable right to recoup federal income taxes in the event of future net losses.

In order to avoid any problems that may ensue as a result of the Department's finding that a particular method of tax allocation is not fair and equitable and/or does not give appropriate recognition to the separate operating identity of the insurer it is recommended that any method other than (A) or (B) above should be submitted to this Department for prior review.

4. For purposes of this circular letter a separate return is defined as a return completed by an insurer as if it were and had been filing as a separate individual taxpayer. However, intercompany transactions which are deferred under a consolidated tax return filing should be recognized.

5. All settlements under this agreement shall be made within 30 days of the filing of the applicable estimated or actual consolidated federal corporate income tax return with the Internal Revenue Service, except where a refund is due the parent, in which case, it may defer payment to the domestic insurer to within 30 days of receipt of such refund. All settlements shall be in cash or securities eligible as investments for such domestic insurer, at market value.

6. If taxable income, special deductions or credits reported in a consolidated federal income tax return are revised by the Internal Revenue Service or other appropriate authority, a recalculation of the tax liability for all parties to the agreement shall be made.

7. The agreement shall be terminated if:

a. The parties agree in writing to such termination.

b. Membership in the affiliated group or consolidated group ceases or is terminated for any reason whatsoever.

c. The affiliated group fails to file a consolidated return for any taxable year.

8. Notwithstanding the termination of the agreement, its provisions will remain in effect, with respect to any period of time during the tax year in which termination occurs, for which the income of the terminating party must be included in the consolidated return.

9. The agreement shall not be assignable by any party, without the prior written consent of the others.

10. The agreement should provide for the arbitration of disputes arising in the implementation of its terms and conditions.

11. The agreement should provide that, notwithstanding its termination, all material including, but not limited to, returns, supporting schedules, workpapers, correspondence and other documents relating to the consolidated return shall be made available to any party to the agreement during regular business hours.

Kindly acknowledge receipt of this letter to: Mr. Alvin H. Alpert, Chief of the Life Insurance and Companies Bureau or Mr. Francis T. Donohue, Chief of the Property Companies Bureau at the New York Insurance Department, 2 World Trade Center, New York, NY 10047.

Very truly yours,

[SIGNATURE]

ALBERT B. LEWIS

Superintendent of Insurance