



PENNSYLVANIA
AMERICAN WATER

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DEVELOPERS, INFRASTRUCTURE INVESTMENTS AND THE TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act (TCJA) of 2017 made changes to federal tax law that have an impact on developers making infrastructure investments in the form of Customer Advances for Construction (CAC) or Contributions In Aid of Construction (CIAC). CAC and CIAC represent the amount of money or property advanced or contributed by a developer to ensure that the expansion of water or wastewater service to new customers or new locations does not unfairly burden a utility's existing customers. Under the new tax law, CAC and CIAC are now federal taxable income to water and wastewater utilities that receive them. Additionally, because Pennsylvania Corporate Net Income Tax is based on federal taxable income, CAC and CIAC are also state taxable income to water and wastewater utilities.

Prior to the TCJA, the tax code treated CAC and CIAC as nontaxable contributions to capital. As a tradeoff, the pre-TCJA tax law prohibited the utility from including system expansion property funded by CAC or CIAC in its rate base for ratemaking purposes, and it also prohibited the utility from taking any depreciation deductions with respect to that property. Because the TCJA now treats CAC and CIAC as taxable income to water and wastewater utilities, the amount of any CAC and CIAC must be increased, or "grossed-up," so that, after paying its income tax liability, the utility's after-tax amount equals the cost of the facility expansion being reimbursed by a developer. The "gross-up" factor is approximately 40 percent of the value of the property being reimbursed and is charged to the developer making the CAC or CIAC.

FAQS ON THE TCJA'S EFFECT ON DEVELOPERS

How does the 2017 tax law impact developer projects within Pennsylvania American Water's service territory?

When developers construct water and/or wastewater infrastructure and turn over the ownership, operations and maintenance responsibilities of that property to the Company, the transferred assets become contributed property to Pennsylvania American Water. As a result, the Company now has a federal and state income tax liability on amounts received since the effective date of the changes made by the TCJA. Prior to the TCJA, these contributions were not taxable income to the Company.

What is the magnitude of the tax liability?

The Company must "gross-up" the CAC or CIAC by approximately 40 percent of the value of the contributed property so that, after paying its federal and state tax liability, the amount left equals the value of the property contributed.



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What is the Company's position regarding this new tax liability?

Pennsylvania American Water has modified its developer agreements to provide that CAC and CIAC will be increased by the gross-up factor to properly account for the federal and state income taxes it incurs when water and wastewater assets are contributed to the Company.

What type of projects are affected by this new provision?

It will apply to projects where the Company receives contributed property from non-governmental entities. Examples include developer turnkey, special facility and water supply agreements, relocations, customer funded bona-fide service extensions, etc. for both water and wastewater facilities.

Has the Company sought guidance from the Pennsylvania Public Utility Commission (PUC) on how it should address the tax law changes affecting CAC and CIAC?

The PUC issued a Secretarial Letter on February 12, 2018, requesting input from utilities on the impact of all of the changes made by the TCJA, including changes that made CAC and CIAC taxable income to water and wastewater utilities. As part of its response, Pennsylvania American Water asked the PUC to rule that the tax liability on contributed property should be fully recognized for ratemaking purposes as a cost recovered in rates from all customers. If that approach is approved by the PUC, it would eliminate the need to gross-up CAC and CIAC to reflect the Company's tax liabilities on contributed property.

What is the current status of the PUC's decision on how to handle the tax gross-up of contributions? Additionally, if the PUC approves rate recovery of the state and federal taxes attributable to taxable CAC and CIAC and allows the Company to not gross-up CAC and CIAC, will the portion of previously paid deposits reflecting the gross-up for tax liabilities be refunded to developers?

The Company has recently asked the PUC to approve a rule that would not require the Company to increase the customer contributions it receives to cover income taxes. The PUC has initially rejected the Company's request, but the Company has filed a Petition for Reconsideration, which was granted pending review on the merits. The Company expects that it could will take the PUC several months to reconsider the Company's request and the Company does not know what the PUC will ultimately decide. Depending on what the PUC decides, the Company may or may not appeal the decision. However, until it is determined whether the Commission will grant the Company's request and the Commission's decision becomes final and non-appealable, the terms detailed herein and in the developer agreement shall apply.

The Applicant shall be required to fully fund the tax gross-up amount prior to the commencement of construction with either a cash deposit or letter of credit, or a combination of the above two options. If a final and non-appealable Commission decision is rendered approving the accounting and ratemaking approvals requested by the Company and,

thereby, relieving the Company of the obligation to apply a tax gross-up factor to CIAC and CAC, the Applicant's tax gross-up amount will be refunded to the Applicant in the manner described hereafter. Otherwise, such funds will be retained by the Company in recognition of the requirement that CIAC and CAC are taxable income to the Company when received.

What should the developers provide for projects in the agreement phase?

Developers will need to furnish Pennsylvania American Water either a cashier's check or letter of credit in the amount of 40.6314 percent of the total project cost to reflect the gross-up for the Company's state and federal tax liability on the contributed property.

If the PUC does not grant the Company the ruling it is seeking, can the developer recover this additional payment through the refunds that become payable under the terms of its developer agreements?

Yes. The amount of each refund will be grossed-up, and the maximum amount that may be refunded will be increased based on the grossed-up total project cost.

Does this new tax provision apply to agreements the Company executed prior to the date of the TCJA?

The Company now has tax liabilities on any contributed property received after December 22, 2017 even if the agreements to make such contributions were executed before that date. Pennsylvania American Water is reviewing whether to apply the gross-up factor to contributions that are made in accordance with developer agreements executed before December 22, 2017.

Do pavement resurfacing costs get grossed-up?

Pave restoration (or resurfacing) costs are part of the overall project costs and should be grossed-up. For new developments where no paving exists, the trench restoration costs should be grossed-up. If the developer paves the roads afterward as part of overall roadway construction, these costs should not be included as part of the overall project costs and therefore they would not be subject to any gross-up.

Are engineering and inspection fees subject to the tax gross-up?

Yes. These services, whether they are performed by the Company or by a third party, are considered as part of the overall cost of the project and become contributed property when the assets are transferred to the Company.

Does the tax gross-up also apply to Company labor?

Yes. This cost is considered part of the overall project cost.

