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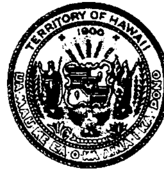


TERRITORY OF HAWAII
DEPARTMENT OF THE ATTORNEY GENERAL
HONOLULU

October 5, 1943

OPINION NO. 1838

TAXATION; PUBLIC UTILITIES TAX; DEDUCTIONS.

In the computation of net income for determination of the ratio of net income to gross income, the loss on supersession of equipment because of extraordinary obsolescence is not deductible.

SAME; SAME; SAME.

In the computation of net income for determination of the ratio of net income to gross income supersession loss cannot be charged to operating expense over a period of years following the retirement of the property.

SAME; SAME; SAME.

The treatment of supersession loss by public utilities commissioners is a matter of administrative policy as to whether the investors or the consumers should bear the loss, and even if the public utilities commission had permitted the loss to be amortized by charges to operating expense account its decision would not have been binding for tax purposes.

SAME; SALE; NATURE OF TAX.

The public utilities tax is in the nature of a property tax,

the net income being an element in the tax rate formula in order to reflect the value of the property, on the same principle as was used in valuing property by capitalization of net income for purposes of the former "enterprise for profit" tax; the loss on abandonment of old property has no bearing on the value of the new property.

SAME; SAME; DEDUCTIONS.

Interest on an assessment of additional federal taxes may be deducted in computing net income for determination of the ratio of net income to gross income.

SAME; SAME; SAME.

In the computation of net income for public utility tax purposes a company on the accrual basis must allocate additional federal taxes to the year of accrual, not the year of payment.

Honorable Wm. Borthwick
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Dear Sir:

This opinion is in reply to your request for advice as to the computation of the Public Utility Tax imposed by Chapter 69, R. L. 1935, with respect to certain items claimed by Honolulu Rapid

Transit Company, Ltd., as deductions in determining the net income of the company, for the purpose of determining the ratio of net income to gross income as provided by Section 2143, R. L. 1935. The disputed items will be considered seriatim, as follows:

1. Track and car abandonment loss.

The company has charged as operating expense each year depreciation on its tracks and street cars. This allowance was taken at depreciation rates based on the estimated service life of this equipment.

On or about June 30, 1940, the company decided to make a complete replacement of this equipment within a year, substituting therefor trolley and motor buses. The company states that these replacements were made because of public demand for new, improved service, and in order that the company might render better and cheaper service, that the replacements were not made exactly in kind but by an improved substitute, and that the events which caused the replacements could not have been predicted previously. The company presents this matter as one involving extraordinary or unanticipated obsolescence, incurred through changing conditions, unanticipated superiority of other equipment, and the desire of the

public for other types of transportation.

The net write off on account of the equipment abandoned, after deduction of depreciation, amortization of a certain item, and salvage, was $887,497.82. Of this total $279,866.90 was for property abandoned in 1940 and the balance in 1941. The territorial public utilities commission has ordered this loss charged off partly to earned surplus and partly to capital surplus.

The taxes involved are the taxes for the year 1941, based on 1940 operations, and for the year 1942, based on 1941 operations. The company claims the right to prorate the total abandonment loss of $887,497.82 over a five year period, 1940-1944, inclusive, and it is the disallowance of the pro rata deductions claimed by the company for the operating years 1940 (tax year 1941), and 1941 (tax year 1942), that are protested.

The tax law provides only for the deduction of "operating expenses and tax accruals, including in the computation of such * * * expenses, debits * * * arising from equipment rents and joint facility rents." Section 2141, R. L. 1935. In the determination of net income for the purpose of fixing the rate of public utility tax, based on the ratio of net income to gross income, there

may not be deducted all of the items allowable by other statutes for net income tax purposes but only those items incurred and accrued in the production of gross income of the same period; moreover, there are no deductions from gross operating revenues other than those enumerated by Section 2141, R. L. 1935, above quoted, to wit, (1) operating expenses, including equipment rents and joint facility rents, and (2) tax accruals. Hawaii Consolidated Ry. v. Borthwick, 34 Haw. 269, aff'd 105 F. (2d) 286.

The company claims the right to write off the balance of cost, in excess of depreciation and salvage, over a period of five years after the property has been abandoned, on the theory that this is an operating expense. You have denied the deduction and have followed Article 4 of your instructions to taxpayers issued November 1, 1937, directing that:

> "The term 'operating expenses' for the purposes of this chapter * * * shall exclude * * * capital losses on retirement of property or equipment properly chargeable to surplus."

Before considering the cases cited by the company, we will take up the nature of the tax. This office has always treated the tax as in the nature of a tax on

property, measured by gross income. At times this treatment has been a benefit to the utilities and at other times not. See Ops. Atty. Gen. (1933-9) No. 1615, Ops. Atty. Gen. (1940) Nos. 1748 and 1751. This treatment was approved in Hawaii Consolidated Ry. v. Borthwick, supra. In disallowing the deduction of interest paid by the company on its bonds the court pointed out that a mortgage would not be deducted from the value of the property if it were subjected to ad valorem tax. Fluctuant variants in income which do not bear upon the value of the property and which would lead to inequality of taxation as between like properties are to be disregarded, the court held. The court pointed out that the introduction of "net income" into the tax rate formula was for the purpose of taking into account "ability to pay", but further made it clear that it is the ability of the property to pay that is meant, not the ability of the proprietors, since the debt to the bondholders was disregarded.

As provided in Section 2140, R. L. 1935, the public utilities tax is in lieu of real and personal property taxes, and the legislative history shows that this tax was substituted for the old "enterprise for

profit” tax and originated with the Tax Board appointed in 1929, which made its report to the Governor January 31, 1931. See the report of the Committee of the Whole, Special Committee Report No. 6, Senate Journal, Second Special Session, 1932, p. 34.

The Tax Board's report analyzes the then existing enterprise for profit tax and points out that under this method property is valued chiefly by capitalization of net income (pp. 17-28). A tax on gross income is then suggested as a remedy for the difficulties inherent in the enterprise for profit tax (p. 34). The report further states that a tax on gross income fails to take earning power into account, and suggests that net income be considered in fixing the rate of tax (p. 35). At pages 38-43 of the report there are set forth calculations by which the rate may be fixed so as to approximate the tax which would be derived by taxing the property after valuing the property by the capitalization of net income method.

While the statute does not contain the formula as worked out in the report (the statutory formula being simpler), this history, coupled with the _Hawaii Consolidated Ry._ decision, shows that "net income", within the

meaning of the statute, is the net income produced by the property, the same net income which was capitalized by the assessor in evaluating property for ad valorem tax, under the "enterprise for profit" provisions. The tax does not fall on the net income and it is just as true of the public utilities tax as it was of the enterprise for profit tax, that:

> "The tax in question is not an income tax, depending for its amount upon the income for the year preceding, but a tax on property the earning power of which is one of the most potent factors in determining its value."
>
> Tax Assessment Appeals, 11 Haw. 235, 237.

Under the statutory formula the net income to be considered is only the preceding year's income. This is not as reliable an index of value as an average of several years income would be, but exactitude is not required in tax acts; convenience of administration may also be considered by the legislature. Hatch v. Reardon, 204 U.S. 152, 159. Within the limits of the statutory formula the act is to be administered so as to ascertain the value of the property through its earning power, as nearly as may be. For this reason the court held in the Hawaii Consolidated Ry. case that fluctuant variants in

income which do not relate to the value of the property and which would lead to inequality of taxation as between like properties are to be disregarded.

The amortization of a loss arising out of the supersession of an old plant by a new plant in a case of extraordinary or unanticipated obsolescence, has no bearing upon the evaluation of the new property for tax purposes. It is a problem in public utility accounting and financing as more fully set forth below. The fact that the new equipment is more economical and gives better service, while sometimes considered by a public utilities commission in determining whether or not the investors may recoup the supersession loss from the rates charged consumers in the future, in so far as valuation of the property is concerned only tends to show that it is more valuable. Pacific Gas and Electric Co. v. San Francisco, 265 U.S. 403, 415.

The company makes no claim that the loss might all be deducted as an "operating expense" of the year of supersession. There would be no authority to support such a claim. Moreover, the deduction of such sudden losses would introduce a fluctuant element contrary to

the intent of the act, as pointed out in the Hawaii Consolidated Ry. case.

What the company does claim is the right to amortize the supersession loss over the five year period following the loss. This claim is based upon an attempted carryover of principles applicable to net income taxation and public utility ratemaking. The income tax principles will be considered first.

The net income tax statute separately provides for the deduction of (1) operating expenses, (2) an allowance for exhaustion, wear and tear of property, including obsolescense, and (3) losses incurred in business. Section 2034, R. L. 1935. Hence, for net income tax purposes, operating expenses do not include provision for obsolescence in any form. The loss and obsolescence provisions cover the matter, it being unnecessary for present purposes to define the application of these separate deduction provisions in a case of extraordinary obsolescence. (See Paul and Mertens Law of Federal Income Taxation, 1st ed., Section 20.111, note 23; Section 20.114; Sections 26.71-26.72; Mertens, Law of Federal Income Taxation, Section 23.105, note 33; Section 23.108.)

Neither (2) nor (3) is contained in the public utility tax law and hence such provisions are inapplicable to public utility taxes. Hawaii Consolidated Ry. v. Borthwick, supra.

Since depreciation is a method of making provision out of current revenues for the ultimate retirement of the property in accordance with a reasonably consistent plan, it may be likened to insurance and considered as an expense of operation, for general tax purposes. See Re Taxes Maui Agricultural Co. Ltd., 34 Haw. 566, 583, citing Paul and Mertens, supra, Section 20.29; Re Taxes Waialua Agricultural Company, 30 Haw. 755, 764; People v. State Board of Tax Commissioners, 127 N.Y.S. 825, 831, Sup. Ct. N.Y. 1910. The regular allowance for depreciation includes obsolescence, in so far as it can be predicted, i.e. normal obsolescence, as distinguished from extraordinary obsolescence, which is sudden, more or less unexpected obsolescence, involving a substantial diminution in usefulness and value over a relatively short period (Paul and Mertens, supra, Sections 20.110 and 20.111, Mertens, supra, Sections 23.104 and 23.105.)

A deduction for extraordinary obsolescence exists by virtue of a specific statutory provision therefor or not at all. Kansas City Southern Ry. Co. v. Commissioner, 52 F. (2d) 372, 375, C.C.A. 8, 1931, cert. den. 284 U.S. 676 Hawaiian Commercial and Sugar Co. v. Tax Assessor, 14 Haw. 601. Extraordinary obsolescence cannot be treated as a deduction from revenues enjoyed in later years, after the supersession has occured, since this would destroy the theory of annual accounting periods followed in the income tax law. Kansas City Southern Ry. Co. v. Commissioner, supra. The holding of the Kansas City Southern Ry. Co. case that extraordinary obsolescence cannot be treated as a deduction from revenues enjoyed in later years, after the supersession has occured, applies to public utility taxes; as held in the Hawaii Consolidated Ry. case the statute contemplates the deduction from gross income of the same period of the aggregate of all items of cost and expenses incurred and accrued in the production of the same. 34 Haw. at p. 276. This principle requires rejection of the company's theory that the retiral loss should be amortized over a five year period from and after the abandon-

ment of the property.

The contention that the loss nevertheless should be amortized out of operating expenses is based upon public utility cases in which certain public utilities commissions have permitted this treatment in so far as practice before them is concerned. These cases are not precedents for tax purposes.

When extraordinary obsolescence has caused the retirement of property the resultant loss is one of the hazards of the industry which must be borne by the investors unless the public utilities commission sees fit to charge the loss against the consumers on the ground that the change benefits the consumers by offering them the same service cheaper, or by offering them better service. State ex rel City of St. Louis v. Public Service Commission, 110 S.W. (2d) 749, 775, Mo. 1937. The treatment of supersession loss by a public utilities commission is a question of policy as to how the loss shall be charged off, and even though a court might feel that it should be entirely charged to earned surplus, the court would not interfere with an exercise of administrative discretion by the commission resulting in a decision to charge a part of it to operating expense. Kansas City Southern

Ry v. United States, 231 U.S. 423, 456. In a tax case involving the same railroad and the same facts it was held that the commission's determination permitting such loss to be charged to operating expense over a fifteen year period was not binding for tax purposes and the deduction was disallowed for tax purposes. Kansas City Southern Ry. Co. v. Commissioner, supra.

The decision of the Supreme Court of the United States that the public service commission's determination as to the accounting treatment of supersession loss is a mere matter of administrative policy necessarily leads to the conclusion that this item is not a true item of operating expense. If it were there could be only one method of treatment, whereas in fact there are several possibilities. In Re Coast Counties Gas and Electric Co., P. U. R. 1931 B 105, permission was granted to amortize the loss through charges to operating expense as an accounting matter, but at the same time the commission required the company to stipulate that, for rate making purposes, it would not charge the loss to operating expense nor include it in the rate base, because the property involved was no longer in service. Permission to amortize supersession loss out of operating expense was

denied in Re Rochester Electric Railway Co., 36 P. U. R. (N.S.) 161. Even where the court is of the opinion that the investors are entitled to some relief the court will not undertake to say whether that relief should take the form of increase of the rate base or the form of recoupment of the loss out of revenues, thereby again demonstrating that the question of charging such a loss to operating expense is a mere matter of administrative discretion. See Pacific Gas and Electric Co. v. San Francisco, supra, 265 U.S. at p. 416.

If public utilities commission decisions were binding for tax purposes then pursuant to Section 7954, R. L. 1935, authorizing the local commission to prescribe the accounting system for this company, the commission's decision that this loss must be charged partly to earned surplus and partly to capital surplus would require disallowance of the deduction.

I am of the opinion that your treatment of this matter in Article 4 of your instructions of November 1, 1937 and in your additional assessment notices is correct.

2. Interest on federal taxes.

For the operating year 1941 (tax year 1942) the

company incurred interest on an assessment of additional federal income taxes. The deduction of such interest has been disallowed. In my opinion it should be allowed.

The interest on an assessment of additional federal income taxes is one of the expenses of determining the tax liability, and ought to be considered an operating expense, the same as accountants' and attorneys' fees in connection with a tax controversy. See Paul and Mertens, supra, Sec. 23.56, Mertens, supra, Sec. 25.40. Disallowance of interest deductions in the Hawaii Consolidated Ry. case was based upon the ground that capital of the public utility business, whether borrowed or not, is subject to tax, and that interest paid to bondholders is no more deductible than dividends paid to shareholders. This principle does not apply to interest on additional federal taxes.

3. Additional federal income taxes.

The company, which is on the accrual basis, paid additional federal income taxes in 1941, and claims the deduction of all of these taxes in determining net income for 1941.

This contention is incorrect. Paul and Mertens,

supra, Sec. 24.20, Mertens, supra, Sec. 27.53. The claim is based on past practice followed during years in which the amount of public utility tax was not affected by the tax deductions.

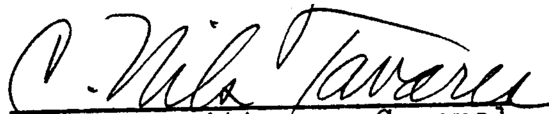
4. <u>Amount of deduction for territorial income tax.</u>

In determining net income for the operating year 1941 (tax year 1942) you have reduced the amount of territorial income tax accrual, on the theory that the additional public utility tax due for the tax year 1941 will reduce the income tax accrual. This matter is noted in the company's protest but requires no special comment.

Respectfully,

RHODA V. LEWIS
Deputy Attorney General

APPROVED:



Assistant Attorney General