

STATE OF NEW HAMPSHIRE
BEFORE THE
NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

CITY OF NASHUA'S PETITION FOR VALUATION PURSUANT TO RSA 38:9

Docket No. DW04-048

DIRECT TESTIMONY OF STEVEN L. PAUL

Q: PLEASE STATE YOUR NAME AND POSITION?

A: My name is Steven L. Paul and I am a partner in the law firm of Palmer & Dodge, LLP, a position I have held since January of 1997. Palmer & Dodge LLP also serves as bond counsel to the City. I have more than thirty years experience in the practice of tax law much of which relates to the taxation of investments in real estate and dispositions thereof. I have served as a visiting lecturer in real estate taxation and finance at Yale Law School and as chair of the Committee on Real Estate of the American Bar Association Section of Taxation.

Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A: I am testifying in support of the City's Petition for Valuation under RSA 38:9. I hope to provide the commission with background concerning the federal income tax consequences of the City's proposed acquisition of the assets of Pennichuck Water Works, Inc., (PWW), Pennichuck East Utility, Inc., (PEU), and Pittsfield Aqueduct, Inc., (PAC and, together with PWW and PEU "Pennichuck") and to respond to any assertions by Pennichuck that such acquisition would result in substantial tax liabilities to Pennichuck and its shareholders.

Q: WILL PENNICHUCK REALIZE A GAIN FOR TAX PURPOSES FROM THE PROPOSED TAKING?

A: Yes. If the water system is taken by eminent domain, Pennichuck will realize a gain for income tax purposes just as it would in a voluntary sale of the assets. The amount of this gain will be the difference between the cash proceeds paid to Pennichuck plus any Pennichuck liabilities assumed less Pennichuck's adjusted tax basis in the assets taken.

Q: WILL ANY REALIZED GAIN BE SUBJECT TO TAX?

A: Not necessarily. Under Section 1033 of the Internal Revenue Code of 1986 (the "Code"), Pennichuck may elect "nonrecognition" of this gain, that is, not to pay tax on it if, within two years after the close of the year in which the transfer of the water system to the City occurs, Pennichuck purchases qualifying replacement property with a cost at least equal to the proceeds of the taking.

Example: If Pennichuck transfers assets subject to \$20 million of debt, receives \$100 million in cash and has a tax basis of \$70 million, it will realize a gain of \$50 million. If within two years it purchases qualifying replacement property with a cost of at least \$120 million, none of this gain will be taxed.

Q: WHAT HAPPENS TO THE UNRECOGNIZED GAIN?

A: The tax basis of the replacement property will be reduced by the amount of any gain not recognized by reason of Section 1033. In the above example Pennichuck's basis in the replacement property for which it paid \$120 million will be only \$70 million (\$120 million cost of the replacement property less \$50

million of unrecognized gain). Thus the \$50 million of untaxed gain is preserved for recognition upon a later sale of the replacement property.

Q: IF GAIN ON THE SALE OF ASSETS WOULD BE SUBJECT TO DEPRECIATION RECAPTURE, IS SUCH GAIN STILL ELIGIBLE FOR NONRECOGNITION?

A: Generally, yes. Section 1033 will override the depreciation recapture rules, provided that Pennichuck preserves any gain subject to recapture by acquiring sufficient replacement property governed by the same recapture provisions as the condemned property. Sections 1250(d)(4) and 1245(b)(4) of the Code.

Q: DOES PENNICHUCK HAVE TO SPEND ALL THE CASH IT RECEIVES IN ORDER TO QUALIFY FOR NONRECOGNITION?

A: No. It can borrow to acquire replacement property. In the above example, if Pennichuck purchased \$120 million of replacement property, by paying \$75 million in cash and borrowing \$55 million, it would have cash of \$25 million left over.

Q: IF THERE IS CASH LEFT OVER FOLLOWING THE PURCHASE OF REPLACEMENT PROPERTY, HOW WOULD A DISTRIBUTION OF THAT CASH TO THE PENNICHUCK SHAREHOLDERS BE TAXED?

A: It would be taxed in the same manner as any other corporate cash distribution: first, as a dividend (generally taxable at a 15% federal income tax rate to individual shareholders) to the extent of the current or accumulated "earnings and profits" of Pennichuck, second, as a tax-free return of capital to the extent of the basis of each distributee in the distributee's shares of Pennichuck and third as

capital gain. Section 301 of the Code. For this purpose, however, the unrecognized gain of Pennichuck from the condemnation is not taken into account in determining earnings and profits. Section 312(f) of the Code. Thus, it is possible that if Pennichuck has cash proceeds from the condemnation following the acquisition of the requisite amount of replacement property many shareholders of Pennichuck could receive distributions of some or all of such proceeds as a tax-free return of capital.

Q: WHAT TYPE OF PROPERTY WILL QUALIFY AS REPLACEMENT PROPERTY FOR THESE PURPOSES ?

A: Generally, qualifying replacement property means “property similar or related in service or use to the converted property.” Section 1033(a). Property similar or related in service or use to the converted property includes a controlling (80%) stock interest in a corporation the assets of which consist primarily of such property. Most significantly, if the property converted is “real property” held for productive use in a trade or business or for investment (and not primarily for sale), qualifying replacement property also includes any other real property acquired to be held either for productive use in a trade or business or for investment. Section 1033(g). Whether property is “real property” is controlled by state law. Rev. Rul. 70-511 and Rev. Rul. 55-749.

Q: IF THE PENNICHUCK ASSETS ARE “REAL PROPERTY” UNDER NEW HAMPSHIRE LAW, MUST REPLACEMENT REAL PROPERTY BE USED FOR THE FURNISHING OF WATER OR POWER?

A: No. Pennichuck can avoid tax on the condemnation of its assets if it purchases any other business or investment real property, regardless of whether such real property is used to furnish water or power or for a similar purpose. The leading illustration of this is Revenue Ruling 73-120, in which the IRS ruled that when the assets of a privately owned water utility corporation were taken by eminent domain, the utility corporation could avoid recognition of gain and payment of tax by purchasing an apartment complex.

Q: CAN YOU PROVIDE OTHER EXAMPLES OF REAL PROPERTY OR AN INTEREST THEREIN THE PURCHASE OF WHICH WOULD OR WOULD NOT ENABLE PENNICHUCK TO QUALIFY FOR NONRECOGNITION OF GAIN UPON THE CONTEMPLATED CONDEMNATION?

A: Yes. The definition of "like kind" real property is quite broad. Land which is unimproved is considered of "like kind" with respect to improved land. A fee estate is considered of like kind to a leasehold interest of 30 years or more. Thus, if (and to the extent) Pennichuck's assets are real property under New Hampshire law, Pennichuck could avoid tax by purchasing unimproved land or a long-term lease of real property. It cannot, however, use the condemnation proceeds to construct improvements on land it already owns because the IRS takes the position that land (improved or unimproved) is not like kind with respect to improvements only. Other examples of the breadth of the inclusion of "like kind" real property as qualifying replacement property are as follows:

- a. 20-acre park with boating facilities operated as profitable business was taken and replaced with an apartment building and another lot to be held as an investment. Rev. Rul. 72-424.
- b. Upon the taking of an easement and right of way, considered interests in real property under local law, replacement with two properties one containing an apartment building and the other only nominally improved resulted in nonrecognition of gain from the taking. Rev. Rul. 72-549.
- c. Agricultural land and buildings which the taxpayer leased to a farmer was condemned for a state highway and replaced by a motel complex operated by the taxpayer. Rev. Rul. 83-49.

Q: IF PENNICHUCK DISTRIBUTED THE CONDEMNATION PROCEEDS TO ITS SHAREHOLDERS, COULD THE SHAREHOLDERS AVOID TAX ON THE DISTRIBUTION BY PURCHASING REPLACEMENT PROPERTY?

A: No. If the assets taken are owned by Pennichuck, it must make the replacement in order to qualify for nonrecognition of gain on the taking. The shareholders cannot receive their shares of the proceeds and make individual purchases of replacement property.

Q: AS A REGULATED UTILITY, PENNICHUCK IS SUBJECT TO ACCOUNTING RULES THAT DIFFER FROM TAX ACCOUNTING? DO THE REGULATORY ACCOUNTING RULES ADVERSELY IMPACT THE ABILITY OF PENNICHUCK TO AVOID RECOGNITION OF GAIN ON THE TAKING OF ITS ASSETS?

A: They should not. For tax purposes Pennichuck has probably been able to depreciate its assets more rapidly than it has for regulatory purposes. As a result, the tax basis of those assets should be less than the net book value of the assets for regulatory purposes. The gain realized for tax purposes should, similarly, exceed the gain realized for regulatory purposes. Because Section 1033 permits nonrecognition of taxable gain, the excess of taxable gain over regulatory gain should not be a concern for Pennichuck.

Q: MIGHT THERE BE ANY TAX ADVANTAGES TO PENNICHUCK FROM CONVERTING ITS UTILITY ASSETS INTO INVESTMENT REAL ESTATE?

A: Following a taking of the utility assets, the purchase of “like kind” real property may provide Pennichuck with tax planning opportunities and advantages that are not currently available to it. For example, Pennichuck might be able to elect to be taxed as a real estate investment trust or REIT, in which case its earnings would no longer be subject to two levels of tax when paid out as dividends. Moreover, after 10 years as a REIT, it could sell the replacement property and distribute the proceeds to its shareholders with only a single level of tax. Finally, whether or not it becomes a REIT, it could borrow or assume indebtedness to purchase replacement property, thereby making portions of the condemnation proceeds available for distribution to the Pennichuck shareholders. As described above, such distributions would not be taxable as dividends to the extent they exceeded the earnings and profits of Pennichuck.

Q: DOES THIS CONCLUDE YOUR TESTIMONY?

A: Yes.