STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

Docket No. DW 13-041

Lakes Region Water Company, Inc.

Motion for Rehearing

NOW COMES Lakes Region Water Company (the "Company" or "Lakes Region") moves for rehearing of Order No. 25,516 as follows:

I. LAKES REGION'S INTENT IN SEEKING REHEARING

Lakes Region Water Company must rely on the advice of others in makings its decisions. As the Commission is aware, due to the Company's small size, it has historically had to rely on outside consultants, particularly for financial advice. The shortcomings of this reliance were clear in this case: the Company believed when it filed for emergency rates that its 2012 unfunded tax liability for $100,219. However, Staff and the Office of Consumer Advocate uncovered errors which, when corrected, reduced the Company's actual 2012 Federal and State income tax liability to $50,873 in 2012,[1] half the amount the Company understood.

In addition, as the Commission noted on Page 8 of Order No. 25,516, the Company's financial schedules, Exhibit 4, show the Company received "net operating income for 2012 of $211,781, even after tax liabilities are accounted for: on page 167 of that exhibit". The Company did not yet have a Financial Manager at the time its financial

[1] As shown in Response to the Commission's Record Request, Exhibit 17, the Company's corrected 2012 Federal Income Tax Liability was $49,975, resulting in an underpayment penalty of $898 as of April 10, 2013. NH BPT and BET taxes totaled $3,281.

exhibits were prepared,[2] and it was unaware that its schedules showed it 'paying' a tax it knows, based on the routine examination of its accounts, it lacks the funds to pay. This is not to say that the Company's Statement of Cash Flows is inaccurate. Exhibit 4 accurately shows the cash flows for 2012 earnings from an accounting perspective. However, Page 167 read alone does not show or mean that the Company has the cash available to pay income taxes. For example, the Statement of Cash Flows booked items such as an Increase in Accounts Payable of $139,602 and an Increase in Accrued Expenses of $92,587.[3] While they are shown as collectively over $200,000 'cash' on the Statement of Cash Flows for 2012 – neither an Increase in Accounts Payable nor an Increase in Accrued Expenses produces an nickel cash available to pay taxes.

The Company's 2012 operating income of $211,781, also included $52,202[4] in permanent rate recoupment intended to correct a prior deficiency in its rates for service rendered during the period from September 17, 2010 to July 13, 2012. See Order No. 25,423. Ironically, the recoupment awarded by Order No. 25,423 was due to a deficiency in earnings, mostly in 2010 and 2011, which contributed to the Increase in Accounts Payable on the Company's books and the Company did not begin to collect it until November 1, 2012. As a result, the recoupment is shown as earnings in 2012, but the deficiencies in earnings for which the recoupment is intended to provide are mostly liabilities incurred prior to 2012, and therefore not shown on the Statement of Cash Flows for 2012. Unfortunately, the Company did not yet have its Financial Manager in place

[2] The responses in Exhibit 4 were prepared on February 22, 2013 under an expedited schedule, prior to the Company's proposal to hire Timothy Fontaine to serve as its Financial Manager on March 5, 2013.
[3] Ex. 4, p. 164
[4] Response to Staff 1-5, Exhibit 4, Page 168.

and the limitations on the use of its Statement of Cash Flows and other financial exhibits should have been more clearly presented by the Company, its consultants and its counsel.

Is the Company to be blamed for the errors of its consultants? If so, should the punishment be the denial of any expense for taxes in its rates, even when the law provides for its recovery?[5] The answer to both questions is no. The Company has sought recovery of tax expense since July 2010 as part of its last rate case in anticipation of its tax expense.[6] On March 5, 2013, the Company completed an extensive search for a Financial Manager to alleviate its reliance on outside consultants, as the Commission suggested in Order No. 25,391. Even if the Company itself were at fault for the weaknesses in its financial exhibits, its financial health and service to the customers are too important to deny when the need for rate relief for tax expenses is something to which the Company is entitled and needs immediately to address its financial condition. The risk the Company faced when it petitioned for emergency rates was (and still is) that if the Commission does not grant its income tax expense in rates, it might not be able to recover it all. Indeed, even Staff suggested that the Company's 2012 and 2013 may not be recoverable and requested guidance from the Commission.[7] Order No. 25,616 declined to provide guidance under the mistaken belief that the Company imprudently amended its returns. However, as explained below, the Internal Revenue Code compelled the Company to use its NOL carry forwards exactly as it did.

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[5] *See Appeal of Pub. Serv. Co.*, 130 N.H. 748, 757 (1988) (Under traditional utility rate setting "the company is customarily allowed to charge customers for tax expenses prior to the actual accrual of the company's tax liability").
[6] Ex. 1, Testimony of Thomas A. Mason, pp. 6-8.
[7] Testimony of Mark Naylor, Transcript, Day 2, Pages 155-156.

The Company continues to make progress. The road may be long, and mostly uphill, but the Company will travel it. In fact, since the Company prepared its filing for emergency rates, its Accounts Payable (excluding income taxes) have reduced from $653,432.28 as of December 31, 2012, to $509,444.66 as of June 26, 2013, which represents a reduction of $143,987.62. See Affidavit of Thomas A. Mason in Support of Rehearing. Like the regulatory challenges that have been largely resolved as a result of Thomas Mason's leadership, the Company will overcome its financial difficulties. The question is: how long will the journey be prolonged due to the on-going accumulation of tax liability for 2012 (and now 2013) that is not reflected in rates?

The Company's tax expense is projected to reach $164,837 by 12/31/2013.[8] As the Commission is aware, the Company reviews its Accounts Payables on a weekly, (almost daily) basis as part of its efforts to control costs. The Commission's denial of revenue for taxes in Order No. 25,616, by the stroke of a pen, effectively eliminates all of the progress the Company has made to move forward and pushes the Company further into a financial position that Staff Witness Mark Naylor described as "unbankable."[9] Rather than give the Company the opportunity to move forward and realize the benefit of its improvements, Order No. 25,616 pushes the Company backwards.

The Company moves for rehearing because it has a job to do: to provide service to the public and to implement the measures expected by the Commission, the

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[8] Mason Affidavit, Page 2.

[9] Testimony of Mark Naylor, Transcript, Day 2, Page 38 ("The issue is, the Company -- we've been talking about a financing with this Company for the last five or six years. And, it's simply not – the Company is unbankable at this point with its balance sheet the way it is. So, I mean, we can debate the specifics of, you know, how -- what loans are acceptable, what terms are acceptable. The fact is, the Company has simply not, for a number of years now, had access or availed itself of access to capital. And, that's a significant problem, and it's a very large factor in this emergency rate request.").

Department of Environmental Services, Staff, the Office of Consumer Advocate, and its customers. Its rates are not excessive by any objective measure. Delay in the recovery of tax expense will cause the Company to remain "unbankable" and thereby impose a risk of non-compliance if capital projects are placed on hold due to an inability to secure financing. Such an outcome is not acceptable to the Company, and it should not be acceptable to the Commission. As explained herein, it is also unacceptable under the law Order No. 25,516 effectively forces the Company to use funds intended to provide for rate recoupment and rate case expense recovery to pay its tax obligations. The Company asks the Commission to grant rehearing in order to allow it, as a necessary component of its service to the public, to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

II. STANDARD FOR REHEARING

The Company requests rehearing of Order No. 25,516 pursuant to RSA 541:3. As the New Hampshire Supreme Court explained in *Dumais v. State Personnel Comm'n*, 118 N.H. 309 (1978), "[t]he purpose of a rehearing is to direct attention to matters said to have been overlooked or mistakenly conceived in this original decision, and thus invites reconsideration upon the record upon which that decision rested." *Id.* at 311 (citing *Lambert v. State*, 115 N.H. 516 (1975) (quotations omitted)). Rehearing is also appropriate where new evidence becomes available which could not have been presented at the hearing. *Appeal of Gas Serv., Inc.*, 121 N.H. 797, 801 (1981); *Dumais*, 118 N.H. at 312.

The Company requests rehearing to direct the Commission's attention to information it mistakenly conceived or overlooked in Order No. 25,516, which resulted

in its denial of an increase in its rates needed to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. This is critical to a water company such as Lakes Region Water because, in the absence of the ability to raise debt and equity that is required to provide service, it can only complete capital projects using earnings derived from customer revenues. By denying the Company its legal right to recover its income tax expense, the Commission effectively confiscated its earnings, its approved recoupment and its future rate case expense recovery, in order to pay taxes.

Under RSA 378:27 & 28, the Company has a right to rates sufficient to allow the Company to earn a reasonable return. *Cf. Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 592, 602 (1944) ("It is not the theory, but the impact of the rate order which counts."); *Appeal of Richards*, 134 N.H. 148, 165-66 (1991) (same); *In re Pub. Serv. Co.*, 130 N.H. 265, 274 (1988) (rate must be just and reasonable); *Hampstead Area Water Co.*, Order No. 24,734, 92 NHPUC 52 (2007) (step adjustment to recognize tax increases just and reasonable). As the Commission itself stated in *In re Pub. Serv. Co. of N.H.*, 90 NH PUC 542 (2005) (Order No. 24,552):

> In Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944), the U.S. Supreme Court set out the relevant constitutional principles, which the New Hampshire Supreme Court has carefully followed in connection with state constitutional jurisprudence, see, e.g., Petition of Public Service Co. of N.H., 130 N.H. 265, 274-75 (1988). The fixing of rates that are just and reasonable, and therefore not confiscatory in a manner that transgresses the U.S. Constitution, "involves a balancing of the investor and the consumer interests." Hope, 320 U.S. at 603. **"From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover,**

> **should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.**

Id. at 551 (emphasis added).

Order No. 25,516 fails by this measure because, instead of focusing on the need to meet its present and future (i.e 2013) tax obligations in order to assure confidence in its financial integrity in order to avoid an emergency, the Commission looked only at 2012 and concluded that if an emergency existed, the Company would not have returned $53,433 to its shareholders in 2012 or invested its earnings in capital projects. While it is certainly true that the timing was unfortunate, the Company's shareholders have never in recent memory earned any approximating a reasonable return on their investment. Due to their immediate medical needs, the payments were book as a return of capital and thereby foregoing an opportunity to earn on the capital.

The Company requests that the Commission consider the Affidavit of Thomas A. Mason in Support of Rehearing, in support of this request. This Affidavit confirms that, notwithstanding the errors in the 2012 tax calculation prepared by the Company's financial consultants, an emergency still exists due to the impact of its on-going 2013 income tax expense that is not included in rates. Equally importantly, the $53,433 for medical expenses that was paid (returned) to its shareholders is overshadowed by the Company's 2013 tax liability that is not included in its approved rates under Order No. 25,391.

III. GROUNDS FOR REHEARING

A. The Commission' Inclusion Rate Recoupment in its Calculation of 2012 Revenue and Rate of Return Violates New Hampshire and Federal Constitutional Principles.

The Commission erred in Order No. 25,516 by including $52,202 in rate recoupment revenue in its calculation of the Company's 2012 earnings that the Commission previously determined the Company was entitled to recover due to deficiencies in its cost-of-service rates for service rendered well prior to 2012. See Order No. 25,423 (Recoupment for September 17, 2010 to July 13, 2012). Under RSA 378:29, rate recoupment is "designed to protect utilities against confiscatory rates and to permit recoupment of any deficiency in return suffered under a temporary order". State v. New Eng. Tel. & Tel. Co., 103 N.H. 394, 395 (1961) (citing Pub. Serv. Co. v. State, 102 N.H. 66, 68 (1959)). Once a rate recoupment is ordered, the Company has both the statutory right under RSA 378:29 and a constitutional property right under the federal and New Hampshire Constitutions to recoup its rates determined to be deficient. In Lakes Region's case in particular, rate recoupment is a critical property right because it is needed to address Accounts Payable (some incurred prior to 2012) that remain on the Company's books.

Order No. 25,516 adopted Staff's inclusion of recoupment revenue that accrued (but was not collected) in 2012 in its calculation of the Company's 2012 earnings. By including this revenue in its earnings, the Commission double-counted the revenue the Company had a right to collect due to a deficiency in its prior rates, in violation of RSA 378:29 and the requirements enumerated in Part I, Article 12 of the New Hampshire Constitution. See *In re Pub. Serv. Co.*, 130 N.H. 265, 274 (1988); *In re Pub. Serv. Co. of N.H.*, 90 NH PUC 542 (2005) (Order No. 24,552).

Removal of the $52,202 in revenue attributable to recoupment from the net operating income of $211,781, Ex. 4, p. 162, *without any other adjustment*, reduces the

Company's actual income in 2012 to $159,579 and its rate of return to 6.57%, below its allowed rate of return, without even taking into account other liabilities incurred in order to provide service to the public.

B. Order No. 25,516 Erred by Treating Increases in Unpaid Liabilities on the Company's 2012 Cash Flow Statement as Cash Available to Pay Taxes.

On Page 8 of Order No. 25,516, the Commission observes that Exhibit 4, prepared by Lakes Region's accountant and financial consultant, shows the Company paying its tax obligation yet realizing a "net operating income for 2012 of $211,781, even after tax liabilities are accounted for: on page 167 of that exhibit". The Commission misreads the Company's 2012 Cash Flow Statement, which includes both cash and cash equivalents, to be a statement of the Company's ability to pay its 2012 (and 2013) tax obligations as follows:

- **Recoupment**. As noted above, the Company's Net Operating Income shown in Exhibit 4 includes $52,202[10] rate recoupment due to prior rates that were legally deficient. See Order No. 25,423. The Company did not even begin to collect this revenue (for service rendered during the period from September 17, 2010 to July 13, 2012 to July 13, 2012) until its November 1, 2012 bills, and its inclusion in 2012 revenue violated RSA 378:29 and constitutional principles. Removal of the recoupment revenue of $52,202 from the Company's gross earnings of $211,781, Ex. 4, p. 162, *without any other adjustment*, results in earnings of $159,579, a rate of return of 6.57%, below its allowed rate of return. Significantly, this recoupment revenue was needed to pay for expenses incurred for service rendered during the recoupment period.

[10] Response to Staff 1-5, Exhibit 4, Page 168.

- **Payment of Interest on Debt**. In 2012, the Company was required to make payments of $73,419 in Interest on Debt. Ex. 4, p. 167. After payment of interest on debt, the Company's 2012 actual earnings (less recoupment), available to pay taxes were further reduced by $73,419 to $86,160! This is far less than the $211,781 net operating income used by the Commission to determine that an emergency did not exist because the Company had the ability to pay its 2012 **and** 2013 income tax expense.
- **Changes in Assets and Liabilities Booked as Cash**. The Company's Cash Flow Statement shows an Increase in Accounts Payable of $139,602; an Increase in Accrued Expenses of $92,587. Ex. 4, p. 164. These items represent an increase in rate case and other expenses incurred in 2012. While these increases in Accounts Payable and Accrued Expenses are shown as 'cash' in the 2012 Cash Flow Statement, they do not represent cash available to pay taxes. Increases in Accounts Payable, such as rate case expenses, may be offset by recovery of rate case expenses and recoupment. See Mason Aff., Ex. A, p. 2 (applying rate case expense recovery and recoupment to accounts payable). However, in 2012 the increases in Accrued Expenses nor Accounts Payable represented a liability on the Company's books, not cash available to pay taxes. Order No. 25,516 erred by including these items as cash flow without considering the offsetting liability on the Company's balance sheet. See Ex. 4, Page 166 (2012 Total Current Liabilities increased from $676,411 to $908,574). In total, the Changes in Operating Assets and Liabilities shown on the Company's Cash Flow Statement, Exhibit 4, Page

164, is shown as $167,350 in cash, but this amount was not in fact available to pay taxes at all.

- **Other Expenditures Required for Public Service**. The Company's investment in Plant and Equipment of $132,621 shown on Ex. 4, p. 164, were required to provide service to the public in order to comply with New Hampshire's Safe Drinking Water Act, RSA 485.[11] Similarly, the Company's Principle Payments on Debt, $143,588, were required to maintain its service to the public. These payments eliminated any cash the Company otherwise would have had to pay taxes.

By considering the above items as earnings in 2012, Order No. 25,516 mistakenly assumed that the Company had the ability to pay its 2012 **and** 2013 tax liability, when it did not and does not have cash available for the purpose. This resulted in the Commission confiscating the Company's shareholder investment in service to the public to pay the federal taxes without any opportunity to earn a reasonable return and which continues to threaten the Company's financial status. The Commission therefore erred by denying its Petition for Emergency Rates.

Order No. 25,516 mistakenly concluded that an emergency does not exist because the Company's 2012 Cash Flow Statement shows that it made cash payments to its sole shareholder shown as $123,356 in 2012. See Financing Activities on Ex. 4, p. 164. As explained by the Company's financial consultants in response to the Commission's Record Request, Ex. 10, the amount shown is correct. However, it reflects both cash and services provided to Mrs. Mason in 2011 and 2012. All of the cash payments occurred

[11] See e.g. John Dawson Testimony, Transcript, Day 1, Page 205; Direct Testimony of John Dawson, Pages 10-11.

before September 2012, and a majority in 2011. In 2012, cash payments to shareholders were $53,443. Ex. 10. Prior to Order No. 25,391 on July 13, 2013, the Company believed that its actual tax expense would be included in rates approved by the Commission. While the timing, as Staff and the Commission noted is unfortunate, the benefit provided to the Company's shareholders is not unreasonable. In fact, Staff could not recall when the Company's shareholders last earned a return on their investment. Except for pension and health care expenses booked as a reduction in equity, there is no evidence that the Company's shareholders ever earned a return on their investment.

C. Order No. 25,516 Erred by Failing to Consider the Company's Legal Obligation to Repay Accounts Payable Incurred due to Prior Deficiencies in Rates.

The purpose of emergency rates is to ensure that the Company is "in a position to meet its cash obligations as they became due: namely, interest and principal payments on debts, expansion of service to customers, and fuel expenses, payroll, and other related expenses". *Petition of PSNH*, 130 N.H. 265, 270 (1988). Emergency rates are, in effect a mechanism to prevent rigid application of utility rate setting principles from confiscating shareholder investment in plant and property to serve the public. After all, "[i]t is not the theory, but the impact of the rate order which counts" *Hope Natural Gas*, 320 U.S. at 602, and the result "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *In re Pub. Serv. Co. of N.H.*, 90 NH PUC 542.

The sole reason the Company was denied a tax expense in Order No. 25,391, and, on rehearing, in Order No. 25,408, was because of the timing, or matching of the tax expense in 2012 to the test year of 2009. After rehearing was denied, the Company's

only choice was to either file a new rate case – thereby adding to rate case expense and unpaid liabilities on its balance sheet – or seek emergency rate relief to avoid the accumulation of tax liabilities on its balance sheet which would render the Company unable to acquire capital and complete capital projects necessary to provide service. By denying emergency rates, the Commission has now prevented the Company from recovering any income tax expense and thereby confiscating its investment in plant and its right to earn a reasonable return as protected by Part I, Article 15 of the New Hampshire Constitution and the United States Constitution as explained in Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 592 and its progeny. Cf. Appeal of Richards, 134 N.H. 148, 165-66; In re Pub. Serv. Co., 130 N.H. 265, 274; In re Pub. Serv. Co. of N.H., 90 NH PUC 542.

D. Order No. 25,516 Erred by Concluding That Lakes Region "Substantially Reduced the Availability of Net Operating Loss Carry-Forwards and Section 179 Carry-Forwards That Could Have Shielded Future Income."

On page 10 of Order No. 25,516, the Commission claims that "Staff and the parties agree that by amending the returns, Lakes Region substantially reduced the availability of net operating loss carry-forwards and Section 179 carry-forwards that could have shielded future income." There is no such agreement by the parties on the record, and the Commission's Order is contradicted by the Internal Revenue Code and established precedent of the United States Supreme Court.

In actuality, the Company clearly stated that the "issue of whether or not the Company should have amended its 2007-2009 (but not its 2010 or 2011)[12] tax returns is

[12] The Company's 2010 and 2011 Tax Returns were filed in 2012 after the Company accepted Staff's recommendations and the shareholder pension and loan expenses were removed from the Company's books.

immaterial. Once the Company accepted Staff's position, it could no longer claim a Net Operating Loss based on treatment of payments to its shareholders as an expense."[13] As a practical matter, the Company had no choice; when the Staff evaluated the Company's books it said that "classification of such payments to an expense account of any kind is imprudent"[14] and that "an adjustment to increase the Company's retained earnings account by the amount of the reclassified shareholder pension and health insurance premium payments may be appropriate."[15]

The Staff's position is very simple: the burden of proof is on the Company to show that it had to use up the net operating losses ("NOLs") prior to tax year 2012.[16] However, before the Commission, Staff's witness Jayson Laflamme, who has recent tax experience with an accounting firm, agreed with the Company's position that, regardless of whether it amended its returns, the Company could not claim NOL deductions that were not supported by its books. He testified as follows:

> **Q. Well, let me ask you this then. You would agree that, wouldn't you, I assume, that, in 2012, the Company can't claim a net operating loss deduction for a pension expense that no longer exists on its books, right?**
>
> A. (Laflamme) In 2012?
>
> **Q. Yes.**
>
> A. (Laflamme) If the Company isn't reflecting a pension expense on its books, then, no, it can't claim it as a deduction.[17]

Mr. Laflamme later reiterated this point:

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[13] See Closing Statement, Page 7 & 7-9.
[14] Ex. 11 (emphasis added).
[15] Ex. 11 (emphasis added).
[16] Trans. Day 2, p. 22.
[17] Trans. Day 2, p. 43.

Q. But the issue I'm trying to get at is, if the Company has, as you had suggested, eliminated an expense from its books, isn't it true that it can no longer claim a loss based on that expense?

A. (Laflamme) If the expense was eliminated from its books, then the Company would not -- should not claim that deduction on its tax returns..

Q. Okay. So, regardless of whether the tax returns were amended or not, you know, the Company has a tax issue in 2012?

A. (Laflamme) Yes.[18]

The Company's position in its closing statement (p. 7-9) and Staff witness Jayson Laflamme's testimony above that the Company could not claim NOLS in 2012 for losses that no longer existed are the correct statement of the law.[19] The Code precludes the Company from using NOLs in 2012 for a loss that no longer existed.

An NOL arises when a company's allowable tax deductions are greater than its gross income. 26 U.S.C. § 172(c); *see also Lisbon Shops, Inc. v. Koehler*, 353 U.S. 382, 384 (1957) (same). Ordinarily, a taxpayer must deduct an expense in the year it occurred. *Brown v. Helvering*, 291 U.S. 193, 199 (1934). Subject to strict limitations, however, the Code allows a taxpayer to carry forward a NOL from one year and deduct that loss against taxable income from succeeding years. 26 U.S.C. § 172(a); *see, e.g., Motors Ins. Corp. v. United States*, 530 F.2d 864, 869 (Ct. Cl. 1976). The purpose of the NOL rules is to "ameliorate the unduly drastic consequences of taxing income strictly on annual basis. They were designed to permit a taxpayer to set of its lean years against its lush

[18] Trans. Day 2, pp. 46-47.

[19] Unfortunately, the Company's financial consultants inartfully advised that the Company was required to amend its returns when the correct advice was that it could no longer claim an NOL deduction for losses for which it was subsequently determined did not exist.

years, and to strike something like an average taxable income computed over a period longer than one year." *United States v. Foster Lumber Co.*, 429 U.S. 32, 42 (1976).

As an exception to the general rule of taxability, the NOL rules are strictly applied. *See id.* at 37 (use of the word "must"). A taxpayer can carry over a NOL only when support for such a deduction can be found in the clear language of a statute, appurtenant regulations, or legislative history. *In re Luster*, 138 B.R. 875, 877 (N.D. Ill. 1992). Thus, if it is subsequently determined that the loss did not occur, the taxpayer cannot carry forward an NOL for a loss that did not exist. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *see, e.g., Yoakum v. Comm'r*, T.C. Memo 2004-191, 2004 WL 1902974, at *2 (Tax Ct. Aug. 26, 2004) (taxpayer not entitled to deduct claimed NOL for a theft where the taxpayer could not prove that the theft occurred). In determining whether a loss existed, "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." 26 U.S.C. § 446(a); *see also Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 531 (1979); Ex. 13, p. 8.

The Company cannot claim carry forwards in 2012 based on expenses that are not supported by its books and records. *Cf. Thor Power Tool*, 439 U.S. at 531. By acceding to Staff's position that "an adjustment to increase the Company's retained earnings account by the amount of the reclassified shareholder pension and health insurance premium payments"[20] – the deductions for those payments as expenses no longer existed and the Company could not claim an NOL in 2012 based on deductible expenses that were not deductible expenses. *Cf. New Colonial Ice*, 292 U.S. at 440.

[20] Ex. 11 (emphasis added).

Nor could the Company have somehow "saved" its NOLs to hold down rates in 2012 by electing to not amend its prior year returns. To the contrary, the ordering of the use of the NOLs is mandated by Section 172 of the Internal Revenue Code; the ordering is not discretionary. *Messina v. United States*, 202 Ct. Cl. 155, 162 (1973). Congress, the Internal Revenue Service, and the courts all posit that the carryforwards have to be used in the earliest year taxable year in the carryover period. See 26 U.S.C. §172(b)(2); Treas. Reg. § 1.172-4(b)(1). *Accord Mutual Assurance Soc'y of Va. Corp. v. Comm'r*, 505 F.2d 128, 129 (4th Cir. 1974); *Garner v. Comm'r*, T.C. Memo. 1981-542, 42 T.C.M. 1181, 1188 (1981); *Galan v. Comm'r*, T.C. Memo. 1976-306, 35 T.C.M. 1377, 1379 (1976); *Mendez v. Comm'r*, 1973 T.C. Memo. 1973-137, 32 T.C.M. 658, 660 (1973). A taxpayer cannot "collect all of [its] NOLs from [2007] through [2011] and apply them *en masse* to [2012] without ever having gone through the mandated process of carrybacks and carryovers." *Hall v. United States*, 99 Fed. Cl. 617, 621 (2011).

In this case, if the Company had not amended its returns to use its NOL carry forwards to offset income in 2007 to 2011 arising from the recharacterization prompted by Staff, the Company would have "left them on the table" because it could not "bank" them. Cf. Hall, 99 Fed. Cl. At 621. The Company had to either use the NOL carryforwards in the first tax year it could or lose them. *Cf. Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("The legal right of the taxpayer to decrease the amount of what othrwise would be his taxes, or altogether avoid them, by means which the law permits cannot be doubted."). Contrary to the ex ante contentions of Staff,[21] the Company could not have "saved" its NOLs to hold down rates for the ratepayers in 2012.

[21] Trans. Day 2, p. 33.

Staff, in essence, wants to have it both ways. In one breath, it expects the Company to recharacterize the payments to Mrs. Mason. When the Company did,[22] and it incurred an increased federal tax liability for 2012 under the NOL rules, however, Staff objected to how the Company used its NOLs.[23] The NOL rules in the Code, however, stand in the Staff's way. The intimation by Staff that the Company should maintain one set of books for the Commisison and a different set for the Service is also precluded by the Code.[24]

Finally, the Commission's Order No. 25,515 mistakenly overlooks the fact that, even if Lakes Region did not amend its prior year returns, its 2012 return would be subject to the tax benefit rule which provides that: "When the event proving the deduction improper occurs after theclose of the taxable year, even if the statute of limitations has run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year rather than to reopen the prior year." *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 380 n.10 (1983). In other words, in the absence of amending the returns, the deductions taken in prior returns had to be re-characterized and applied against the NOLs in 2012 once the Company accepted Staff's recommendation to treat the shareholder loans and pensions as an increase to retained earnings. What the Company actually did by amending its prior year returns "is the kind of thing that is done all the time. . . ." Id. at 426 (Blackmun, J., dissenting). Otherwise, when a taxpayer's return is audited[,] a deficiency is asserted due to an overstated deduction. . . ." Id. The Commission, thus, would have ended up in roughly the same place which makes perfect

[22] Trans. Day 2, p. 20.
[23] Trans. Day 2, pp. 22, 33.
[24] Trans. Day 2, pp. 19-20.

sense, given the purpose of the NOL rules is to average income over time. See id. at 378 n.11.

WHEREFORE Lakes Region Water Company respectfully requests that the Commission grant this motion for rehearing and such other relief as justice may require.

Respectfully submitted,

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By its Counsel,

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Dated: July 5, 2013

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was this day forwarded via Electronic Mail to all parties on the official Discovery Service List for DW 13-041.

Justin C. Richardson