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Renewable Energy Tax Bill Update: No Change to PTC and ITC and Some BEAT Changes

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Summary

The tax bill passed by Congress on December 20, 2017, contains many improvements for renewable energy from the original House draft of the tax reform bill, including retaining existing credits and reducing the impact of the base erosion anti-abuse tax on renewable energy tax credit projects, but some issues remain.

In Depth

On December 20, both houses of Congress passed the much-discussed tax reform bill (Bill), which contains provisions that could impact the energy sector. As in prior drafts proposed by the House and Senate, the Bill proposes significant reductions in the corporate income tax rate, a deduction creating a reduced tax rate for some partnerships and other pass-through entities, and 100 percent expensing of many capital expenditures. The Bill also leaves untouched the existing section 45 production tax credit (PTC) and section 48 investment tax credit (ITC) statutes. It also repeals the corporate alternative minimum tax (AMT) and improves the formula for calculating the base erosion anti-abuse tax (BEAT) when PTC, ITC or other credits have been claimed by the taxpayer.

Summary

No Change to the PTC and ITC

The Bill does not provide for any changes to the PTC or ITC sections of the Code. Thus, the PTC remains available at the current rate for wind projects, which began phasing down for projects beginning construction in 2017. Furthermore, the Bill does not eliminate the PTC inflation factor or codify the PTC continuous construction requirement, both of which proposals had been included in

the House version of the Bill.

The Bill does not eliminate the 10 percent ITC for solar projects where construction begins in 2028 or later, or codify the ITC continuous construction requirement, both of which had been included in the House version. Instead, the Bill retains the current ITC phase-out schedule for solar energy; that is, the ITC is reduced from 30 percent to 26 percent where construction begins in 2020; 22 percent where construction begins in 2021; and 10 percent where the facility is not placed into service before January 1, 2024, and where construction begins in 2022 and beyond.

The Bill does not extend the ITC for the so-called "orphan" tax credits relating to fiber optic solar energy, fuel cell property, microturbine property, combined heat and power system property, small wind energy and thermal energy. There is some momentum for these technologies, including PTC technologies like biomass, geothermal and hydropower, to be extended in a separate piece of legislation, but it is unclear at this time how likely it is that such an effort would succeed.

Reduced Tax Rate for Corporations and Repeal of AMT

The Bill reduces the corporate tax rate to 21 percent beginning in 2018. The Bill also repeals the corporate AMT, which was an important improvement on the Senate version of the Bill. While the ITC currently can be used to offset AMT, the PTC can only offset AMT for the four year period beginning on the date a PTC project was placed in service. Given the likelihood that corporations would be subject to corporate AMT with the reduction of the corporate tax rate, the corporate AMT provision was expected to have a chilling effect on the PTC tax equity market.

BEAT

The Bill provides some good news and some bad news for PTC and ITC with respect to BEAT when compared to the Senate earlier proposals. See our *On the Subject* on the Senate bill's BEAT provisions. The good news: 80 percent of PTC and ITC can generally be used to offset a taxpayer's BEAT. The bad news: a change to the threshold amount of the BEAT has made it more likely that multinationals fall within the BEAT, and the BEAT rules lack carryforward provisions for credits limited in a given year.

What is the BEAT?

In brief, the BEAT is a new tax intended to apply to companies that significantly reduce their US tax liability by making cross-border payments to affiliates. If the cross-border payments reduce a company's US tax liability to less than 10 percent of its US taxable income (discussed further below), the BEAT applies.

To whom does the BEAT apply?

The BEAT applies to corporations with US taxable income that are part of a group with at least $500 million of annual gross receipts (averaged over a 3-taxable-year period) and which have a "base erosion percentage" of 3 percent(2 percent in the case of certain banks and registered securities dealers) or higher for the taxable year. This 3 percent amount is one percentage point less from the threshold for BEAT application that applied under the Senate bill, making it slightly easier to fall within the BEAT purview. The "base erosion percentage" generally equals the aggregate amount of "base erosion tax benefits" (in brief, tax benefits, such as deductions, resulting from payments to foreign affiliates) of the taxpayer for the taxable year, divided by the aggregate amount of the deductions

allowable to the taxpayer for the taxable year.

How do PTCs and ITCs factor into a taxpayer's BEAT calculation?

The BEAT is a tax equal to the taxpayer's "base erosion minimum tax amount" for the taxable year. In simplified terms, this amount is determined by a formula that compares 10 percent (which will increase to 12 percent for years after 2025; for certain banks and registered securities dealers, the 10 percent is replaced by 11 percent and increased to 13.5 percent for years after 2025) of the taxpayer's income without taking deductible payments to foreign affiliates into account with the taxpayer's regular tax liability (taking such deductions into account and reducing by certain credits, as discussed below). If the 10 percent amount is larger, then the BEAT is owed.

In calculating the company's regular tax liability, certain credits are taken into account, making it more likely that such a company is subject to the BEAT. However, in contrast to the original Senate BEAT proposal where 100 percent of the PTC and ITC would be taken into account in this computation, the Bill provides that only 20 percent of the PTC and ITC must be taken into account. In more formal terms, the Bill provides that a company's regular tax liability is reduced by (1) the credit allowed under section 38 for the taxable year which is properly allocable to the research credit determined under section 41(a), plus (2) the portion of the applicable section 38 credits not in excess of 80 percent of the lesser of the amount of such credits or the base erosion minimum tax amount (determined without regard to this clause (2)). The applicable section 38 credits referred to in this formula are the low-income housing credit determined under section 42(a), the PTC, and the ITC for energy property.

The Bill does not include provisions permitting the carryforward or carryback of credits subject to limitation under the aforementioned formula. Thus, 20 percent of the PTC and ITC might be effectively denied in any given year, depending on a taxpayer's BEAT status and relevant computations.

Reduced Tax Rate for Income from Pass-Throughs

The Bill proposes a new tax regime for income distributed from pass-through entities (*e.g.*, sole proprietorships, partnerships, limited liability companies and S corporations). Owners of such entities are currently taxed income from these entities at their individual or corporate income tax rate. Under the Bill, beginning next year, individual taxpayers may deduct 20 percent of their "qualified business income" from a pass-through entity.

The deduction is subject to limitation equal to the greater of (i) 50 percent of W-2 wages paid with respect to such trade or business or (ii) 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (the capital limitation). The capital limitation was a new addition under the Bill, and qualified property for purposes of this limitation is, in general, tangible depreciable property used in the relevant trade or business.

As in prior proposals, service heavy trades or businesses would not be eligible for this deduction, such as trades or businesses in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.

100 Percent Immediate Expensing of Capital Expenditures

As expected, the Bill allows taxpayers to take an immediate deduction for the full amount of many capital expenditures. This provision would be in lieu of the current “bonus depreciation” rules for certain “qualified property.” Those rules require deducting the cost of the qualified property over its depreciable life, with a 50 percent deduction in the first year. The Bill would allow an immediate deduction of 100 percent of the cost of all qualified property acquired and placed in service before January 1, 2023, with a phase down through January 1, 2027. “Qualified property” generally retains its definition; that is, it includes tangible property which has a recovery period of 20 years or less under the current Modified Accelerated Cost Recovery System (MACRS) depreciation system, as well as certain computer software, water utility property and qualified improvement property. Under the Bill, qualified property would not generally include any property used by a regulated public utility company. The Bill eliminates the existing requirement that the original use of the property begin with the taxpayer and, therefore, used property acquired by a taxpayer may be eligible for 100 percent expensing assuming that property is not acquired from a related party.

Contributions to the Capital of a Corporation under Section 118

The Bill retains the general rule under Section 118(a) that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. It also provides a new exclusion from the general rule in Section 118(a) for any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). However, the Bill contains a grandfather rule for contributions made by a governmental entity pursuant to a master development plan approved by a governmental entity prior to the date of enactment. The Bill also repeals the special rules related to contributions to capital with respect to water and sewage disposal utilities in Section 118(c). The House Bill had proposed repealing Section 118 altogether. The potential repeal of Section 118 would have changed long-standing rules allowing contributions made to utilities to fund interconnect or transmission upgrades to be treated as non-taxable contributions by the utilities. Those arrangements are no longer affected by the Bill.

New Rules for Advance Payments under Section 451

The Bill adds the new Section 451(c), which is intended to codify the current deferral method of accounting for advance payments for goods, services and other specified items under Rev. Proc. 2004-34. That is, the provision allows accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes. The Bill explanation notes that this language is intended to override any deferral method provided by Treasury Regulation § 1.451-5, which generally allows a seller to account for an advance payment at the time the sale related to such advance payment is accrued by the seller either for book or tax purposes, whichever is earlier. This provision could accelerate the recognition of prepayments received under power purchase agreements.

New Markets Tax Credit Unchanged

The Bill does not propose any changes to the new markets tax credit in Section 45D. The House Bill had proposed eliminating the new markets tax credit.

Elimination of Technical Termination of Partnerships

The Bill follows the House version and repeals Section 708(b)(1)(B), the partnership technical

termination rule. This rule provides that a partnership terminates upon the sale or exchange of 50 percent or more of the total interest in partnership capital and profits in any 12-month period. The technical termination rule was form-driven and even certain internal transfers of partnership interests could potentially cause a termination of the partnership. The primary effect of such a termination was that the partnership must “restart” its depreciation in the year of termination, which is generally economically detrimental to the partners. Partnerships will no longer have to consider whether a technical termination has occurred upon a transfer of a partnership interest.

Disallowance of Interest Deductions

Under the Bill, most businesses would be subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business’ adjusted taxable income. For years beginning after December 31, 2017, and before January 1, 2022, taxable income is reduced by depreciation, amortization and depletion. Businesses with average gross receipts of $25 million or less would generally be exempt from this disallowance. Additionally, the provision would not apply to certain regulated public utilities.

Repeal of Section 199 Deduction

The Bill would repeal section 199, which currently provides a deduction for qualified domestic production activities income.

Conclusion

It remains to be seen what the overall effect of the BEAT and the other provisions discussed herein will be on renewable energy projects. The changes to the corporate tax rate and the addition of the BEAT will certainly narrow the tax equity market for renewable energy, although it is unclear at this time by how much.

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