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Legal Alert: Energy Tax Changes Proposed by House Republicans Tax Reform Bill

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On November 2, 2017, Republicans on the House Committee on Ways and Means released their much anticipated tax reform bill, titled the Tax Cuts and Jobs Act (as modified by Chairman Brady on November 3 and November 6, the House Plan). The House Plan is far-reaching and contemplates significant changes to how the United States would tax individuals, domestic businesses and multinational businesses. The legal alert discusses the energy tax related provisions in the House Plan.[1]

Eversheds Sutherland Observation: Republicans aim to pass a tax bill by the end of the year. The introduction of the House Plan is a significant step toward that goal. However, the House Plan is likely to undergo further revision before it is voted on by the full House. In addition, it is expected that the Senate Finance Committee will release its own tax reform bill this week. While the Unified Framework was intended to guide both tax-writing committees, the Senate bill could differ from the House Plan in meaningful ways (for example, the corporate integration plan favored by Chairman Orrin Hatch was not included the House Plan). Given the comprehensive changes contemplated by the House Plan, individuals and businesses will need to carefully follow (and consider steps to mitigate) the potential impact of the House Plan as well as legislation expected to be released by the Senate this week.

- **Production tax credits (PTCs).** There are two significant changes in the House Plan to the PTC provisions of IRC § 45. First, the inflation adjustment amount for the PTC would be eliminated for projects the construction of which begins after the enactment of the legislation. As a result, those projects would be entitled to a 1.5 cent per kWh credit as opposed to a 2.4 cent (with continuing adjustments for inflation) per kWh credit. Second, the House Plan states that to be treated as having begun construction, there must be "a continuous program of construction" from the date on which construction begins until the project is placed in service. The addition of that language suggests that the begun construction requirement can be satisfied only through the actual physical work test and not through the 5% safe harbor.

Eversheds Sutherland Observation: Should these provisions be enacted: (1) the value of an ITC in lieu of PTC may be greater for new wind projects than the value of the PTC; and (2) projects that satisfied the 5% safe harbor in 2016 may no longer be treated as having begun construction in 2016 (such that the project may no longer be entitled to the full amount of PTC). Further, it is unclear whether the 4-year safe harbor for continuing construction would be retained. It is possible that the use of the phrase "a continuous program of construction" was not intended to limit the begun construction requirement to the physical work test (but rather was the result of rushed drafting), but if that is the case, further

clarification is needed.

In addition, the PTC was not extended in the House Plan for non-wind technologies, and therefore continues to be unavailable for new projects utilizing the technologies that were not extended by the 2015 PATH Act.

- **Investment tax credit (ITC).** The House Plan repeals the permanent 10% IRC § 48 ITC (for solar projects that are unable to claim the 30%, 26% or 22% ITC) for projects the construction of which begins after 2027. In addition, the House Plan extends the ITC for qualified fuel cells, small wind, microturbine, combined heat and power, and thermal energy property. Finally, the House Plan adds beginning of construction language similar to that provided for the IRC § 45 PTC.

Eversheds Sutherland Observation: Although the House Plan did not extend the IRC § 45 PTCs for technologies left behind in the 2015 PATH Act, the House Plan does extend the ITC for certain technologies. In addition, the IRS has been working on solar beginning of construction guidance that would need to be revised to take into account any changes to beginning of construction rules intended by the House Plan, as discussed above, and to address the additional technologies.

- **Fuels tax credits.** The tax credits for biodiesel and alternative fuels available under IRC §§ 40A, 6426, 6427 and 34 expired at the end of 2016. The House Plan does not reinstate those tax credits

Eversheds Sutherland Observation: There had been some indications that the biodiesel tax credits and alternative fuels tax credit would be either extended in their prior form or converted to a production tax credit. The House Plan does neither.

- **Nuclear PTC.** All allocations of the 6000 MW for which the nuclear PTC are available under IRC § 45J have been allocated. However, as a result of construction delays, not all such allocations are expected to be used. The House Plan provides that after January 1, 2021, Treasury would reallocate any part of the previously allocated 6000 MW that was not used, first to facilities that did not receive an allocation equal to their full capacity and thereafter to facilities placed in service after such date. Further, certain public utilities would be entitled to transfer their allocation of credits to specified other persons involved with the project.

Eversheds Sutherland Observation: This proposal has been expected as a result of recent construction delays and cancellations of nuclear facilities.

- **Reduction in corporate tax rates.** The House Plan generally reduces the statutory corporate tax rate from 35% to 20%. In connection with the proposed reduction in corporate tax rates, the House Plan includes a provision to “normalize” the treatment of excess deferred taxes created by that reduction. Essentially, the bill adopts the average rate assumption method used to reverse the excess deferred taxes created by the Tax

Reform Act of 1986

Eversheds Sutherland Observation: The House Plan provides that to the extent there is excessive flow through, the "penalty" apparently is simply to reverse the excessive flow through. Although the House Plan refers to §§ 167 and 168 of the Code and declares excessive flow through of excess deferred taxes to be other than a normalization method of accounting, it does not cleanly tie back to the Code's disallowance of the right to claim accelerated depreciation and a clarification to that effect would be advisable.

- **Extension of bonus depreciation.** The bonus depreciation rules under IRC § 168(k) currently generally provide for 50% bonus depreciation for certain property placed in service before 2018, 40% bonus depreciation for property placed in service in 2018, 30% bonus depreciation for property placed in service in 2019, and 0% for 2020 and later years. The House Plan proposes to amend IRC § 168(k) by generally increasing bonus depreciation to 100% for property placed in service after September 27, 2017, and before January 1, 2023. The House Plan also would eliminate the requirement for bonus depreciation that the property be originally placed in service by the taxpayer. The House Plan excludes from these changes any property used by a regulated public utility (or property used in a real property trade or business).

Eversheds Sutherland Observation: The exclusion of public utility property from expensing is tied to the exclusion of public utilities from the interest expense deductibility limitations discussed below, yet avoids forcing utilities to elect one or the other subject to regulatory scrutiny and second-guessing. In recent years, the availability of bonus depreciation has produced net operating losses for many utilities.

- **Interest deductibility.** Under the House Plan, net interest expense would be disallowed to the extent that it exceeds 30% of the business's adjusted taxable income (taxable income computed without regard to interest income and expense, NOLs, depreciation, amortization and depletion). This provision does not apply to certain regulated public utilities (or real property trades or businesses). However, interest deductions also may be limited under a provision that applies to multinationals to limit interest deductibility to the extent that the U.S. group is over-levered as compared to the global group. This provision applies if the U.S. group's share of the global group's net interest expense exceeds 110% of the U.S. group's share of the global group's EBITDA.

Eversheds Sutherland Observation: The interest expense limitations are not likely to have a material effect on most utilities (other than multinational utilities and utilities with significant nonregulated operations), although questions remain how to allocate interest between utility and nonutility operations.

- **Net Operating Losses.** Taxpayers would be permitted to offset only 90% of their taxable income with NOLs (similar to the current corporate AMT).

NOLs could be carried forward indefinitely and would be increased by an interest factor intended to preserve their value. However, NOLs would generally not be permitted to be carried back.

Eversheds Sutherland Observation: Although the inapplicability of expensing for utilities will mitigate the likelihood and magnitude of new NOLs, the elimination of carrybacks for new NOLs is not particularly helpful. Moreover, as the bill applies to "any NOL," it presumably eliminates the ability to claim extended carrybacks under § 172(f)(3) for specified liability losses including those attributable to nuclear decommissioning costs.

- **CIACs.** Under current law, non-shareholder contributions to capital may or may not be includable in the taxable income of the recipient corporation. The House Plan proposes to revise these rules so that all contributions to capital would be includible in the gross income of the recipient corporation to the extent that the fair market value of the contributed assets exceeds the fair market value of any stock that is issued in exchange for such contributed assets.

Eversheds Sutherland Observation: A common question is whether equipment transferred to a utility is includible in the utility's taxable income under IRC § 118 and IRS Notice 2016-36 (as well as other IRS guidance). Under the House Plan, contributions to a utility would be taxable to the recipient utility (and, therefore, generally subject to a tax gross-up from the contributor).

The IRS and Treasury have indicated that IRS Notice 2016-36 may be updated to clarify certain issues regarding the taxability of equipment contributed by a generator to a utility. If this provision is included in final legislation, such legislation would override IRS Notice 2016-36 and no further clarification would be needed.

- **Residential energy efficient property.** Under the House Plan, this credit would be extended for all qualified property placed in service prior to 2022; however, for property placed in service in 2020 and 2021, the tax credit rate would be 26% and 22%, respectively.

- **Repeal of EOR credit and credit for producing oil and gas from marginal wells.** These credits would be repealed under the House Plan for all years after 2017.

See our Tax Reform Law blog for more information, including the text of the House Plan, the House Ways and Means Committee Summary, the Joint Committee on Taxation Explanation.

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[1]See Eversheds Sutherland general Legal Alert regarding the House Plan, which addresses other provisions that potentially may impact both the energy and non-energy sectors.

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