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Legal Alert: A Comparison of the Energy Tax Changes in the Proposed House and Senate Tax Reform Bills

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On November 9, 2017, the Senate Finance Committee released a Description of the Chairman's Mark of the "Tax Cuts and Jobs Act" and on November 14, 2017, the Senate Finance Committee released a Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act," both prepared by the Joint Committee on Taxation (the Senate Plan). The Senate Plan, like the parallel Tax Cuts and Jobs Act under consideration in the House of Representatives (the House Plan), is far reaching and contemplates significant changes to how the US would tax individuals, domestic businesses and multinational businesses, including companies in the energy sector. This alert summarizes the principal proposals in the Senate Plan that impact the energy sector and notes meaningful differences from the House Plan.[1]

Visit the Eversheds Sutherland Tax Reform Law blog for more information and for tax reform updates.[2]

Eversheds Sutherland Observation: Republicans aim to pass a tax bill by the end of the year. The House Plan was passed on a party-line vote by the House Ways and Means Committee and was passed today by the full House. The Senate Plan shares many similarities with the House Plan. However, as discussed in greater detail below, there are meaningful differences in the substance of the two proposals. Additionally, Republicans have chosen to advance the Senate Plan under the Congressional reconciliation process, which permits certain legislation to advance with 50, rather than 60, votes. Under the Byrd rule, legislation passed this way can only be permanent (i.e., not sunset as the Bush tax cuts did) if it is not projected to increase the federal deficit outside of the 10-year budget window. It is not yet clear what impact the Byrd rule will have on the Senate Plan. Given the extensive changes contemplated by the Senate Plan (and the parallel House Plan), companies in the energy sector will need to carefully follow and consider the potential impact of proposed tax reform.

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- **Energy Tax Credits.**

House Plan

Production Tax Credit (PTC): The House Plan makes two significant changes 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.

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.

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.

Nuclear PTC: All allocations of the 6,000 MW for which the nuclear PTC is 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 6,000 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.

Residential Energy-Efficient Property: 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 Enhanced Oil Recovery (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.

Senate Plan: The Senate Plan does not modify existing law related to any of the energy tax credits addressed in the House Plan.

Eversheds Sutherland Observation: Although the Senate Plan does not address energy tax credits, Senator Chuck Grassley (R-Iowa) indicated on November 15, 2017, that the Senate is expecting to tackle energy tax credits in an extenders bill at the end of this year.

- **Reduction in Corporate Tax Rates.**

House Plan: 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. The reduction in corporate tax rates is effective beginning in 2018.

Senate Plan: In this respect, the Senate Plan is nearly identical to the House Plan, also generally reducing the statutory corporate tax rate from 35% to 20% and including a provision to "normalize" the treatment of excess deferred taxes created by the reduction. However, under the Senate Plan, the reduction in corporate tax rates is not effective until 2019.

Eversheds Sutherland Observation: Both the House Plan and Senate Plan provide 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 sections 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. A clarification to that effect would be advisable.

- **Extension of Bonus Depreciation**.

House Plan: 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).

Senate Plan: The Senate Plan would also generally increase bonus depreciation to 100% for property placed in service after September 27, 2017, and before January 1, 2023. The Senate Plan does not eliminate the requirement that property be originally placed in service by the taxpayer. The Senate plan would exclude from its definition of qualified property certain public utility property.

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.**

House Plan: Under the House Plan, net interest expense would be disallowed to the extent that it exceeds 30% of a business's adjusted taxable income (taxable income computed without regard to interest income and expense, net operating losses (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 US group is over-levered as compared to the global group. This provision applies if the US group's share of the global group's net interest expense exceeds 110% of the US group's share of the global group's earnings before interest, taxes, depreciation and amortization (EBITDA). The House Plan generally permits business interest to be carried forward for up to five years

Senate Plan: The Senate Plan disallows deductions for net interest expense in excess of 30% of a business's adjusted taxable income. Adjusted taxable income is computed without regard to NOLs (but unlike the House Plan, includes depreciation, amortization and depletion). Certain regulated public utilities (along with real property trades or businesses) are excepted from this provision. Interest deductions for multinationals may be limited if the US group is over-levered as determined by excess domestic indebtedness. The Senate Plan uses a different measure of over-leverage than the House Plan. Under the Senate Plan, the interest deduction is limited to the extent the amount by which the total indebtedness of the US members exceeds 110% of the total indebtedness they would hold if the US debt-to-equity ratio was proportionate to the ratio of the worldwide group. The Senate Plan generally permits indefinite carryforward of disallowed business interest deductions.

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 non-regulated operations). However, questions remain on how to allocate interest between utility and non-utility operations.

- **Net Operating Losses.**

House Plan: 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.

Senate Plan: The Senate Plan would generally limit NOL deductions to 90% of taxable income (80% after 2023) and would permit NOLs to be carried forward indefinitely and increased by an interest factor intended to preserve their value. 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 section 172(f)(3) for specified liability losses including those attributable to nuclear decommissioning costs.

- **Contributions in Aid of Construction (CIAC).**

  House Plan: Under current law, non-shareholder contributions to capital may or may not be includible 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.

  Senate Plan: The Senate Plan does not modify existing law regarding contributions to capital.

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). While the IRS had taken the position that contributions to capital of a partnership were taxable because IRC § 118 did not apply, the House Plan removes any ambiguity by stating that gross income includes any contribution to the capital of any entity.

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 the House Plan provision is included in final legislation, such legislation would override IRS Notice 2016-36, and no further clarification would be needed.

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[1] See our general legal alert regarding the Senate Plan, which addresses other provisions that potentially may impact both the energy and non-energy sectors.

[2] This legal alert is based on the Joint Committee on Taxation's description of the Senate Plan as the text of the Senate's version of the Tax Cuts and Jobs Act has not yet been released.

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