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Tax Cuts and Jobs Act of 2017: effect on renewable energy tax credit transactions

By Forrest Milder

Here's a summary of things that we are noticing about the recently adopted tax legislation generally referred to as the Tax Cuts and Jobs Act of 2017 (there's more about the name of the law at the end of this alert), focused on renewable energy tax credits (or RETCs); see our separate alert for more a generalized review of several tax credits.

Overview

For the most part, the changes to RETCs are not that obvious. Most of the changes are due to the incidental effects of changed depreciation rules, or new rules regarding the deduction of interest. Here's one thing that ***didn't*** happen: None of the proposed negative changes were adopted—the begun construction test for many technologies continues to benefit from the IRS's four-year safe harbor for determining whether the project has been in continuous construction (but note: the IRS still hasn't published a comparable safe harbor for solar), and the inflation adjuster that elevated the 1.5 cent production tax credit to 2.4 cents in 2017 remains as well. And, here's one thing that ***did*** happen: repeal of the corporate alternative minimum tax, which will benefit wind PTC transactions; before the change, the wind PTC had been subject to the AMT in years 5 through 10.

Orphan credits

While the so-called "orphan energy credits" were not addressed in this Act, a bill has already been filed to grant them extended periods to begin construction and qualify for credits.

Cap on business interest

One of the new provisions that has the tax equity community searching for guidance is the new rule that caps a business's interest expense at 30 percent of its adjusted taxable income. Of course, many tax equity deals depend on borrowing, and this threshold is often exceeded. A few things to consider:

Exception for electricity and certain other activities

The limitation does not apply to interest incurred by taxpayers in the trade or business of furnishing or selling (1) electrical energy, water or sewage disposal services; (2) gas or steam through a local distribution system; or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale may be established or approved by a state or political subdivision, or any agency or instrumentality of the United States, or by a public service or public utility commission or other similar government body, or the governing or ratemaking body of an electric cooperative. This looks like the definition of a "public utility," but it could conceivably apply to a RETC project that derives its income from a power purchase agreement (or PPA) if it is subject to the approval of one of the listed agencies. That's not entirely good; such an entity is also not entitled to use bonus depreciation, as discussed below.

Real property trade or business exception

There is also a savings feature for "real property trades or businesses" (RPTOB) engaged in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business that make an election to use the "alternative depreciation system" (or ADS) for its real estate. Typical energy deals do not involve real estate, so the RPTOB election is unlikely to affect RETC deals.

Small gross receipts exception

The interest limitation does not apply to taxpayers whose average annual gross receipts for the three-tax-year period ending with the prior tax period do not exceed $25 million. However, this exception does not apply to "tax shelters," which would be expected to include RETC investment transactions.

Computations

The interest limitation is computed annually at the partnership level, but once computed, all record keeping is then done at the partner level. In particular, any deduction allowed after applying the limitation becomes part of each partner's non-separately stated taxable income or loss from the partnership. And any interest that is not allowed on account of the limitation is allocated to each partner as "excess business interest." The partner then keeps track of this excess business interest carry-forward, and it may deduct its share against its "excess taxable income" (essentially income in those years to the extent that the 30 percent interest limitation is not used up) from future partnership years of the same partnership. Excess business interest reduces the partner's basis in its partnership interest (even if it cannot currently use the deduction), with any basis reduction being restored if the partner disposes of its partnership interest, effectively reducing its gain (or increasing its loss) on disposition.

Application to transactions closed under prior law

The new interest cap applies to tax years after 2017, which means that even "old" deals can be subject to the new rules, regardless of when the property was placed in service.

Back leverage and partner-level borrowing

The cap on deducting interest leads to other questions. Analysis of these rules at the entity level seems obvious, but what about interest incurred on borrowing at the investor level, say to bridge the receipt of the investor's capital contributions? And how should "back leverage" interest incurred by a general partner or managing member to make its capital contribution be treated? While there isn't yet specific guidance on these particular rules, there is analogous support for using "any reasonable method" in the IRS's "interest tracing rules" under Section 163. There's even an IRS notice that specifically discusses the acquisition of partnership interests and capital contributions to partnerships. In the end, there seems to be pretty decent support for applying these old rules to the new interest cap provisions as well.

The BEAT

The jury will be out for a while on the impact of the Base Erosion and Anti-Abuse Tax.[1] The computation and application of the tax are enough to make your hair hurt. Essentially, it's a minimum tax for certain corporations, with a rate of five percent in 2018, then 10 percent for several years and then increasing to 12.5 percent for tax years beginning after 2025 and a one percent higher rate for banks and securities dealers. It would take a lot of space to describe just how the BEAT works, but here's the very general overview: the corporations potentially subject to the BEAT are those that average over $500 million of annual revenues for which at least 3 percent (2 percent for banks and securities dealers) of their deductions are intercompany deductions with their foreign affiliates. As originally proposed, the BEAT was indifferent to the taxpayer's tax credits (other than the R&D credit, which was, and still is, fully exempt from its application). If the taxpayer had more tax credits, it might (depending on its particular facts) have a lower regular tax, but a correspondingly higher BEAT, thereby undermining the usefulness of tax credits. In any case, as finally enacted, the BEAT treats the RETC (and the LIHTC) more favorably than the HTC and NMTC. That's because, at least for the next few years, up to 80 percent of the RETC and LIHTC can be used to reduce the BEAT, while none of the HTC and NMTC can be used. Eventually, the favorable treatment for the RETC and LIHTC is scheduled to go away, and for taxable years beginning after 2025, none of the credits will be able to reduce a taxpayer's BEAT. It is very important to recognize that application of the BEAT will be very client specific, and many tax credit advisors are suggesting that relatively few potential investors will be affected. Query whether this will cause any investors to move to the more favored credits, or will they still see even a 20 percent reduction in value as too large to justify the investment.

Bonus depreciation and capital account issues

Various items discussed here can have complex effects on the partnership's capital account computations:

Bonus depreciation

The size of an investor's capital account can matter when it comes to being allocated its negotiated share of partnership tax items, with losses reducing it to zero. The new Act once again provides 100 percent bonus depreciation commencing with placed-in-service dates after September 27, 2017 (provided there was not a contract to acquire the property prior to that date, in which case the prior 50 percent rule applies) through the end of 2022 (and phasing down thereafter) and taking such large losses quickly can wipe out an investor's capital account even faster. Without going into a graduate course on the Section 704 regulations, suffice it to say that whether to elect out of bonus depreciation and/or take on a deficit restoration obligation (or DRO) will continue to be an important question for RETC investors for several more years. One important note—as mentioned above in the discussion of the interest cap, a defined group of businesses that are subject to government-approved rates, including providing electricity, are neither subject to the interest cap nor eligible to use bonus depreciation. We're studying whether and how this rule might apply to RETC transactions.

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[1] We covered an earlier BEAT proposal at length in our prior alert, "Do you know the BEAT?" (available here).

Capital accounts
Losses disallowed by the new 30 percent cap on interest deductions likely reduce a partner's capital account, even if it can't use them. This would be consistent with the basis reduction rules, described earlier. The technical application of these rules will also have a significant effect on the structure of transactions.

Changes in tax rates

Of course, tax rates for corporations are falling from 35 to 21 percent, and the new rates go into effect for tax years beginning after 2017, as proposed in the House version of the bill. While this reduces interest in losses (because they are now only worth 21 cents per dollar), there are some other effects for the tax credit industries:

State credits
Straight sales of state credits will be far less costly. Sales of state credits formerly yielded 65 cents on the dollar unless a tax-exempt or similar strategy was available. The new rate increases the net yield to 79 cents.

Other income and gain items
The 50(d) income that arises in pass-through transactions now results in a far lower tax bill, while gains or losses generally associated with the sale of the investor's interest will be taxed at a lower tax rate.

The name of the new law

Finally, one slightly humorous note. Yes, the Parliamentarian in the Senate really did require that the Bill not have the name "Tax Cuts and Jobs Act." So, as of now, it doesn't actually have a name. For convenience, we'll continue to use that name anyway, or a la the late musician, Prince, we may call it "The Act formerly known as the Tax Cuts and Jobs Act."

For more information on the new tax law and its application to your tax equity transactions, please contact your regular Nixon Peabody attorney or:

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