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Summary of Effect of Selected Provisions from HR1 on the Renewable Energy Tax Credit Industry

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H.R. 1, the tax reform bill, was signed into law by President Trump today. Now that we have the conference report, it's possible, with some certainty, to analyze what the Act means for the renewable energy tax credit (RETC) industry.

First, the good news:

The existing investment tax credit under IRC Section 48 (solar) and IRC Section 45 (wind) were not affected and remain unchanged. To achieve this result, the RETC industry had to dodge a couple of bullets.

First, in its version of the bill the House proposed to eliminate the permanent 10 percent investment tax credit for solar and geothermal projects after 2027.

Second, the House bill attempted to claw back the PTC extension agreed to in December 2015 by proposing to repeal the inflation adjustment of PTC rate of 1.5 cents per kWh over the 10-year credit period (a 37.5 percent reduction compared to PTC rate of 2.4 cents per kWh under current law). This proposal, which blindsided the wind industry would have applied to wind projects that commenced construction after passage of the bill.

To add insult to injury, House bill added confusion to the "continuous construction" requirement in a way that created unintended adverse consequences for some developers that had already committed to a safe harbor strategy.

Thankfully, none of the above provisions above made it into the conference agreement. As a result, for the most part, the RETC industry fared much better than it could have given the legislation that was on the table for discussion.

In summary, there are five changes that will likely have a notable effect on the renewable energy industry:

1. Lower Corporate Tax Rate

The corporate tax rate is reduced from 35 percent to 21 percent starting in 2018. Due to this lower tax rate, tax losses (depreciation deductions) will generally be worth less. On the flip side, post flip cash flows from existing operating projects/transactions, cash flows from operating projects/existing transactions owned outright (including sale leasebacks) are certainly now more valuable given the lower corporate tax rate. Independent power producers, developers and sponsors with portfolios of operating projects may be tempted to sell or monetize their portfolios. Anecdotally an increase is expected in the volume of sales of existing projects (including sponsor interests) in 2018.

For existing transactions, due to the tax losses being worth less, an investor will likely be short of tax benefits which could cause a delay in the flip date if such transactions have targeted yield provisions. To the extent the investor has already claimed the lions share (if not all) of the depreciation deductions the flip date could be accelerated. For new transactions, because tax losses are now worth less with a 21 percent tax rate, the increased value ascribed to post flip cash flows would indicate that in order for tax equity to remain constant more cash flow will need to be shared with the investor and/or the buyout price from the call option will need to be sized higher. If this cannot be accomplished tax equity capital in any given transaction will decrease. As they say in the London subway sponsor/developers will need to “mind the gap” with sponsor equity or debt.

A number of transactions that closed in the last five months or so assumed the higher 35% corporate tax rate and tax equity investments were sized accordingly. To protect themselves against the effects of potential tax reform, investors preferred that sponsors use a “targeted IRR” approach which requires the developer/sponsor to make the investor whole with the targeted IRR mechanism. With the impending passage of the bill Novogradac & Company is already running financial projections with the new 21% tax rate for numerous transactions that closed in 2017.

2. Base Erosion and Anti-abuse Tax (BEAT)

The Senate bill created a new alternative tax calculation that subjects large multi-national corporations to a potential base erosion and anti-abuse tax (BEAT). The BEAT is an alternative tax meant to discourage these corporations from shifting (stripping) earnings overseas via domestic deductible payments to foreign affiliates. The BEAT tax rate is 5 percent in 2018 (6 percent for banks and securities dealers), 10 percent in 2019 to 2025 (11 percent for banks and securities dealers, and 12.5 percent after 2025 (13.5 percent for banks and securities dealers). Ultimately, BEAT is meant to ensure that multinational companies pay at least a 10 percent tax on taxable income that includes domestic deductible payments to foreign affiliates. Fortunately, payments on swaps and other derivatives, a very material number for many banks, were excluded from the definition of payments to foreign affiliates in a last minute change to the bill.

The BEAT has the potential to erode a RETC’s investor’s benefit from the ITC and PTC by up to 20 percent through 2025, and up to 100 percent thereafter. This is because tax credits that provided no value due to BEAT cannot be carried forward. Renewable energy developers are concerned the BEAT could have a detrimental effect on the tax equity market. Tax equity investors subject to BEAT who are unsure whether full benefit for the credits will be achieved are likely to sharply curtail or cease making tax equity investments altogether. Most industry practitioners are of the view the amount of tax equity in 2018 will be adversely affected by BEAT but the market will continue to function. The only question is to what degree. Thankfully, the final bill limits the potential for the BEAT to negate the value of ITCs, PTCs and low-income housing tax credits (LIHTCs) to 20 percent of such credits claimed from 2018 through 2025. Tax equity investor should be able to get full value for 80 percent of these credits due to a last minute change in the bill. Lobbyists wanted 100 percent of the credits to be able to offset the BEAT but had to settle for 80percent.

Multinational corporations (especially the big banks with significant overseas operations and affiliates) will be reviewing their exposure to BEAT liability. Some of these investors may find that they have exposure to BEAT and may cease making tax equity investments, limit their tax equity investments and/or remarket some or all of their existing tax equity investments with future exposure to the BEAT.

Wind PTC transactions look to be the most affected by BEAT. Because the PTC has a 10-year credit period (like LIHTC) investors in existing PTC transactions are at risk BEAT could render up to 20 percent of the remaining credits worthless. For prospective transactions tax equity investors will likely place a discount on, or value only 80 percent of PTCs from 2018 through 2025. PTCs after 2025 could be viewed as worthless given 0% of them can offset BEAT after 2025. More than likely, unless a tax equity investor is confident of no BEAT exposure, wind developers elect to claim the ITC in lieu of the PTC on new transactions. After 2025 is anyone's guess. Solar tax equity investors must generally look only at their current year BEAT exposure and invest accordingly. That said, current tax equity investors' exposure to BEAT could affect pricing in 2018 and forward; a challenge for developers who will need to make up the financing shortfall but a potential boon to investors with no BEAT exposure.

3. Interest Expense Limitation/Alternative Depreciation System

Interest expense deductions are limited to 30 percent of a taxpayer's income (determined at the partnership level for most project cos.). Starting in 2018 interest deductions on debt will be suspended to the extent a company's net interest expense exceeds 30 percent of its adjusted taxable income. Fortunately, the adjusted taxable income calculation allows a taxpayer to add back depreciation and amortization through 2021. Assuming the taxpayer elects out of 100 percent asset expensing renewable energy deals should be sheltered from these rules though 2021. After 2021 adjusted taxable income will be a smaller amount meaning the limit on interest deductions is more likely to come into play.

The interest expense deduction limitation will mostly impact highly leveraged project level transactions with investor targeted yield provisions. Simply, suspended interest expense deductions will adversely impact investor yields. Sponsors with significant project level debt will likely choose back levered debt facilities (or other sources of financing) as an alternative in order to avoid this issue.

The limit on interest deductions does not apply to small businesses (defined as those with gross receipts of less than $25 million) and regulated utilities. Existing indebtedness is not grandfathered under the bill.

4. 100 Percent Asset Expensing

The final bill increases "bonus depreciation" from 50 percent to 100 percent effective for property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023 (subject to an exception for regulated public utilities). If the property was acquired (or was to be acquired under a binding contract) prior to Sept. 27, 2017 and placed in service after Sept. 27 the property will still qualify for bonus depreciation; just at a lesser rate (50 percent to 30 percent). One hundred percent bonus depreciation expires Dec. 31, 2022. It then phases down 20 percent a year until 2026. Regulated public utilities are not eligible for bonus depreciation. That said, as referenced above, regulated utilities are not subject to the interest expense deduction limitations. Some investors elect out of 100 percent bonus depreciation to preserve their capital accounts and avoid reallocations of depreciation deductions (and potentially tax credits) to the sponsor.

For the first time ever the bill allows bonus depreciation on used property as the property is not acquired from a related party as defined. The impact of this provision on the pricing of acquisitions of operating projects needs to be further analyzed.

5. Prepaid Power Contracts (PPAs)

Prepaid power purchase agreements are increasingly common in the solar space. Previously income from these prepayments was often recognized as taxable income consistent with how the income was recognized for financial statement purposes; typically, over the life of the power contract. The bill will require these "advanced payments" to be recognized as taxable income immediately in the year of payment or, at best, if an election is made, over two years. This could put some pressure on the tax equity pricing in transactions involving advanced payments on PPAs. Note that the rules relating to prepayments on lease agreements are still in place. In such instances prepaid lease payments (and the corresponding lease expense) are still generally recognized as taxable income and as a deduction over the term of the lease.

Other Provisions

Other provisions in the Act also will affect the renewable energy industry, though the magnitude remains to be assessed.

1. Repeal of Technical Termination Rule

The Act repeals the technical termination rules of Section 708. Under current law, transfers of more than 50 percent of interests in the profits and losses of a partnership cause the deemed termination of the partnership, and the formation of a new partnership. Property held by the partnership is then re-placed in service, and depreciable lives start over, generally reducing annual depreciation deductions. With the repeal of the technical termination rules, depreciable lives will not restart, so there should be no leakage in the value of depreciation deductions on existing assets due to a change in ownership.

2. Accelerated Income Recognition Based on Audited Financial Statements

Starting in 2018, taxpayers will generally be required to recognize taxable income no later than the taxable year in which such income is recognized on their audited financial statements. This rule applies solely to companies that use the accrual method of accounting. The impact of this provision, at the project level and at the investor level, needs to be further analyzed.

3. Orphaned Technologies

The Senate plan was for the orphaned technologies (which include fuel cells, CHP, geothermal heat pumps, microturbines, fiber optic solar etc.) to be included in an extenders bill. The House bill had extended these expired tax credits. As of this writing the Senate has introduced a new extenders bill. The timing of when it might pass is uncertain.