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The BEAT of a Different Drummer: The 2017 Tax Reform and The Tax Effects on Renewable Energy

Direct and indirect impact of new BEAT tax magnifies wind vs. solar investment considerations

Part 1

This two-part series aims to portray a clearer picture of the new tax law changes on renewable energy tax equity finance. Because, ready or not, the BEAT goes on.

INTRODUCTION

Although the U.S. Congress left the federal production tax credit (PTC) and federal investment tax credit (ITC) for solar legislatively unchanged in the 2017 overall tax reform effort, tax equity investors and project sponsors now must assess a new reality caused by the creation of a new Base Erosion Anti-Abuse Tax (BEAT). This new income tax regime is now a variable requiring renewable energy project sponsors and investors to take note, and take stock, of their previous investment analysis as well as plans involving tax equity.

Fortunately, the renewable energy sector remains strong and so it appears that the sector's capital markets will adjust to the new economic reality imposed by the Tax Cuts and Jobs Act (TCJA) of 2017.

POLICY BACKGROUND OF THE BEAT

From the beginning, the TCJA first introduced by the U.S. House of Representatives created considerable concern among renewable energy operators and investors, because it threatened to alter the terms of the PTC and ITC itself. Fortunately, the concern quickly dissipated when the Senate failed to adopt or support the draconian House version of the law. But that relief was short-lived, because shortly thereafter, a new U.S. Senate tax proposal came to light. At the last minute, the Senate imposed of a new form of tax, one that reached foreign transactions of both domestic and foreign companies with U.S. effectively connected income.

The stated purpose of the BEAT was to “pay for” part of the “cost” of lowering overall U.S. corporate income tax rates to 21%, as well as create a tax-policy based disincentive to move U.S. earnings off-shore. Unfortunately, with the creation of the BEAT the U.S. Congress adopted a policy that in practice indirectly struck at both the PTC and the ITC by impacting tax equity investors.

TAX REFORM

The most notable impact of the federal income tax overhaul is the reduction of the federal corporate income tax rate to 21%. This reduction itself has its own separate impact on tax equity financing of renewables, which some have projected will reduce tax equity by 3-10% of the capital stack in a typical tax equity financing.

In addition to the lower overall rate impact on tax equity, other notable tax law changes include elimination of full interest expense deductibility for most businesses, a new 100% bonus depreciation (that has a sunset clause), and several other income tax accounting rules that depart from prior law. These additional income tax accounting changes impact renewable energy financing transactions, depending on the circumstances of each transaction. These other changes to the law are covered in detail, in part two of this series.

Therefore, while the impact of the 2017 tax reform law does not appear to be overly concerning to many in the renewable energy sector, it is nonetheless true that now, overall, the current U.S. income tax law is generally less favorable to the U.S. renewable energy tax equity market than in previous years. In part, this is due to the cumulative impacts of multiple tax rules applying simultaneously to a financing, rather than just one tax law change itself.

THE BEAT INDIRECT IMPACT

For example, the way that the new BEAT tax imposes a burden on renewable energy tax equity financings is subtle. The BEAT operates negatively by ultimately causing the federal income tax reduction (savings) provided by federal general business income tax credits (like the PTC and ITC)¹ to be partially ignored for the federal income tax accounting purposes of calculating the BEAT tax. These tax credits are not allowed to fully offset the BEAT tax, and under the new law, render the PTC and ITC useless in reducing the non-BEAT “regular” income tax. This in turn renders the PTC or ITC of limited economic value as compared to both the regular and AMT² tax rules in force prior to the new law. Also, under the new BEAT rules, any lost value of the PTC or ITC cannot be carried forward or used later to offset future tax liabilities. It’s simply wiped away.

Therefore, the materiality of the BEAT may somewhat dampen overall investor attraction to U.S. renewables until the corporate treasurers of tax equity investors can calculate the impact of the BEAT on those corporation’s income tax liabilities; and the extent to which those impacts may trigger a change in tax equity investment behavior by those investor-corporations directly because of the BEAT and because of lower corporate tax rates and other factors under the new tax law. Again, until a corporation knows precisely whether it will owe the BEAT tax or knows how much of its PTC or ITC tax credit value may be lost because of the BEAT, the attractiveness of a PTC or ITC is reasonably presumed to be diminished if held by an investor subject to the BEAT or one who reasonably expects to be taxable under the BEAT provisions.

SEVERITY OF CHANGE

Investments in projects “old and cold” may unfortunately be affected by the change in law, because the new law creates direct and indirect impacts that now must be dealt with over the life-span of multi-year tax credit streams, some of them cumulative.

Specifically, for projects claiming the PTC, the impact of the BEAT not only exists for the current tax year where a PTC from a prior year’s investment exists, but for up to 10-years on any new PTC investment. There’s even a potential for the problem to go longer than 10-years if regular tax credits are carried forward from prior non-BEAT years even though there is no provision under the new law for carrying forward current year credits rendered unused by the BEAT.

In addition, whether a tax-equity investor is subject to the BEAT may change year to year, because a corporation moving into or out of the BEAT is based on that corporation’s specific annual cross-border taxable business activity and can change year to year depending on business transactions.

Also, it’s too early to tell how new tax planning solutions may develop which could provide an adequate solution to some of the legal challenges posed by the BEAT. Currently, there appear

to be tax planning solutions that may mitigate, if not eliminate the impact of some of the new tax rules. It remains to be seen if such BEAT-avoidance strategies may develop permanently in compliance with the tax law.

Because the U.S. Treasury and IRS do not intend to release detailed guidance until December 2018, nor short term guidance until summer of 2018; and because U.S. Congress is not expected to pass technical tax reform correction legislation until well after the mid-term 2018 congressional elections, taxpayers at all levels are forced to wait in some level of legal uncertainty as all await official government clarification.

BEAT—TILTING THE BALANCE BETWEEN RENEWABLE TECHNOLOGIES IN THE U.S.

Preliminary assessments of the BEAT impact on tax equity were initially dire. However, the initial dire apprehension appears to be waning as corporate treasurers and tax professionals become more familiar with the new BEAT rules, even despite minimal guidance so far from U.S. tax authorities. Nonetheless, the BEAT does appear to potentially disadvantage the wind sector as compared to the solar sector, simply because the federal PTC is materially different from the federal ITC from a tax accounting perspective.

IMPACT ON WIND SECTOR

Current federal income tax rules allow PTC-eligible wind projects to elect the ITC in lieu of the PTC. However, in most cases, electing the ITC will result in fewer tax credits than with the PTC being utilized. This is due to a technical legal limitation (which results from the ITC being based on project cost alone) and explains why the wind sector in today’s market would still say it prefers the PTC to the ITC in a wind deal, if given the unimpaired choice of credit.

This is also impacted by the trend of reducing costs coupled with increased wind production. Modern wind technology grows increasingly efficient in energy production, and the result is that wind farm tax equity transactions that elect to claim the PTC will commonly generate substantially more production tax credits (PTCs), simply because of the prolific physical electrical output of the modern wind-turbine. This higher physical production enables wind project sponsors to raise considerably more tax equity than would mathematically be allowable under the ITC. Thus, the wind project developer and investor preference for the PTC vs. the ITC for most wind projects with high capacity factors.

Unfortunately, for taxpayers currently unable to predict their annual BEAT tax liability as far forward as the ten-year PTC annual tax credit stream, the advent of the BEAT now adds a brand-new type of tax uncertainty for those tax equity investor’s expecting to owe a BEAT tax.

This new unknown created by the BEAT may increase the attractiveness of the ITC for some investors, but only to the extent that the ITC would not be limited by the BEAT in the

¹Except for the R & D Tax Credit, which is not reduced in the case of a BEAT tax.

²Alternative Minimum Tax. Existed under pre TJCA law, eliminated for corporations as part of the TJCA.

year the ITC becomes available for the investor to use. Another reality raised by the BEAT is whether those holding an interest in a PTC project as an investor should consider disposing of their ownership stake in the partnership, and if so, the economics and tax impacts of doing so. Given the likely higher present value of the PTC vs. the ITC, it's more likely than not that the developer will choose a tax equity investor that is willing to take the longer-term risk vs. allowing the investor to choose (especially under a yield based structure).

IMPACT ON SOLAR SECTOR

Though the ITC for solar was also not directly altered by the new tax law, the primary impact of the new law on the solar sector also arises from the new tax accounting rules that independently impact the wind sector, namely the BEAT, overall corporate rate reduction, interest deduction limits, and AMT elimination, etc.

To the extent that the BEAT renders an investment in a 10-year PTC tax credit stream less attractive, some renewable energy investors may judge that a solar ITC project could be a sufficiently more attractive investment than a wind PTC or a wind ITC project. This is because the tax equity investment cost of a solar ITC investment varies from the cost of a PTC investment whose credits are claimed annually over 10 years. However, this may potentially generate much more competition (triggered by lower yields) for large utility scale wind projects.

Most investors will assess these investments differently, depending on how they estimate their BEAT liability, their time value of money calculation, total investment, holding period criteria, and other factor compare directly to a 10-year PTC investment.

Therefore, the greater relative near-term certainty of the one-time, up-front solar ITC could make solar ITC investments attractive in cases where the value of a PTC wind project or even a wind ITC investment fails to compare favorably.

THE OVERALL VALUE OF TIME

It will take time for tax equity investors with foreign tax activities that may subject them to the BEAT tax to truly measure their BEAT exposure. It will also take time for the Treasury and the IRS to provide the industry with tax guidance that address the tax uncertainties the industry now faces.

What still must to play out is whether and to what extent some of the BEAT tax impacts may be mitigated or eliminated with acceptable corporate tax planning and structuring. Tax planning may yet provide acceptable workable solutions.

For now, the initial legal uncertainty remains, tempered by the fact that so far, the predicted negative impact of the BEAT on tax equity investments has largely not yet materialized in the first quarter of 2018.

However, for those corporations not subject to the BEAT (mainly because they do not have foreign activity that is required for any BEAT tax to be imposed), there may be new interest in the PTC or ITC. With the corporate AMT now eliminated, corporations previously interested in AMT reduction may now find the PTC and ITC attractive for regular tax minimization. For those domestically taxed corporations, we anticipate that even at the 21% corporate rate there will be an appetite for corporate tax minimization via the use of U.S. federal income tax credits. If so, the process of educating a new class of corporate tax equity investor will again be necessary.

The TCJA and Tax Effects on Renewable Energy

Multiple tax law changes combine to complicate analysis of tax equity transactions

Part 2

In Part-1, we tackled the impending and expected impacts of the BEAT and macro-concerns surrounding the Tax Cuts and Jobs Act and the impact on tax equity. We also speculated on potential for differentiation between wind and solar investments. Here, in part 2 of the series, we cover other pertinent tax law changes and conclude with some good news for the renewable energy sector.

INTRODUCTION

The introduction of the 2017 Tax Cuts and Jobs Act (TCJA), or “tax reform,” created a considerable amount of discussion among renewable energy operators and investors. What began as fear of the unknown and a panic triggered by an extremely punitive tax policy against renewables proposed by the U.S.

House of Representatives, quickly vaporized only to be substituted with a much subtler handicap known as the BEAT.

OTHER TAX LAW CHANGES OF NOTE

While there are many more tax reform-related law changes that may ultimately significantly impact a renewable energy project, here are a few of the more notable provisions included in the recent tax legislation.

100% Bonus Depreciation

Most tax equity investors and project sponsors were relieved to learn that what the U.S. Congress touted as “100% tax expensing,” instead took the form of 100% bonus depreciation. Had Congress passed a law requiring expensing, it could have

been fatal to the depreciation portion of the capital stack and the investment tax credit (ITC) because expense deductions would reduce depreciation essential for qualifying for the ITC. Therefore, the fact that Congress chose to increase the bonus depreciation regime (rather than replace it with a full expensing regime), and phase-out the bonus percentage over time, was met with wide approval, even though most tax equity financings do not utilize bonus depreciation.³

Separately, some sponsors and investors are hailing another important change to the bonus depreciation regime, namely allowing certain used property to be eligible for bonus depreciation. While this change does create opportunities for some sectors of the renewable energy industry, the rule remains that neither PTC nor ITC credits are allowed on used equipment.

Nonetheless, those in the repowering sector have expressed interest in this new feature of the U.S. tax depreciation regime despite the continuing prohibition on claiming either PTC or ITC tax credits on used, 'second-use' property. The depreciation rules and the tax credit rules remain distinct from each other even under the new law.

Interest Deduction Limitation

The new U.S. tax law was in part "paid-for" by "raising revenue/reducing taxpayer deductions" and does so by imposing a limitation on the amount of business interest that taxpayers may deduct in any taxable year.

The scope and impact of this provision is broad. It encompasses the interest expense on pre-existing business loans, as well as future new loans made in 2018 and beyond. It pretty much has the potential to hit everyone. It does so by allowing taxpayers to only deduct 30% of otherwise deductible interest expense, thereby reducing tax deductions that would in turn lower taxable income. The result is that despite allowing 70% of the unused interest deductions to carryforward and be used in future years, the 30% limit still applies each year, thereby effectively increasing the tax owed if other types of deductions or tax credits are not available to reduce one's tax. The tax accounting rules that apply to this 30% limit are also complex, particularly in partnership settings.

While the legislative history and subsequent comments by the Joint Committee on Taxation (JCT) indicate that the legislative intention of the interest deduction limitation was to impact the largest multi-national corporations and not U.S. small business, it appears, at least with respect to PTC and ITC tax equity transactions, that the legislation has failed its own test. Consequently, there appears to be a serious unintended consequence that may disproportionately impact PTC or ITC structures with small businesses as partners.

Specifically, the rules under section 163(j) of the new law provide an express exemption from the interest deduction



limitation to small businesses that are not tax shelters and that have average annual gross receipts for the three-year period ending with the prior tax year that do not exceed \$25 million. Businesses that meet this test are not required to limit their interest deduction.

However, a careful reading of the legislative text broadly defines a "tax shelter" as a "syndicate," and the definition of syndicate just happens to include many tax equity transactions that allocate more than a third of the tax losses to a limited partner/investor in a partnership.

The precise way in which the law was drafted appears to clearly prevent most tax equity transactions from qualifying for the small business exemption on the ability to deduct business interest if they otherwise could qualify. Thus, unlike most other U.S. small businesses that don't rely on tax equity partnership financing structures, the wind and solar sector is caught up in being denied full annual interest deductibility.

Other industries like Section 42—low-income housing credit, historic rehabilitation, or even some new markets tax credit transactions may avail themselves of a separate real estate election to avoid the tax shelter exclusion under section 163(j). Public utilities are also exempted from the interest limitation.

However, because wind, solar, and other section 45 or section 48 technologies are generally not invested in real estate and can't claim the real estate exemption, PTC and ITC tax equity transactions appear to now be legally disadvantaged by the tax law, at least to the extent that some portion of their overall partnership tax structure has a partner that otherwise may meet the \$25 million small business exemption from the interest deduction limitation. In many cases, the sponsor will be the taxpayer impacted by this rule.

³It should be noted that the actual legislative caption of the bill uses the term "expensing" but the text of the law makes clear that it's depreciation, NOT expensing for purposes of IRC section 168(k), et. seq.



In response to this legal issue, some are appealing to U.S. Congress and U.S. taxing authorities to treat renewable energy projects as public utilities for being eligible for the separate public utility exemption from the interest deduction limit. However, the statute as written is unfortunately too narrow to allow for such an interpretation.

This problem affects pre-existing deals as well as new deals, and the new law is expected to remain problematic, especially for financings employed using so-called “back-leverage.”

It appears that a legislative amendment is needed, though prospects of that appear unlikely, at least until the 2018 mid-term congressional elections.

Because guidance from the federal taxing authorities is not expected for many months, the lack of firm legislative details has raised the prospect of concern that this might increase uncertainty in the market in a legal environment where no one truly knows the full scope of the new interest-deduction limitations. However, we have yet to see this concern concretely materialize in a meaningful way.

For now, appealing to congress is a new action item for the renewable energy tax equity industry.

Other Tax Law Impacts to Watch

Federal tax law changes always have ripple or spill-over impacts, even if only indirectly, to the state and local levels.

As states adjust to the new federal tax regime, the tax impacts at the state level will undoubtedly impact nearly every project, because projects are physically located, and involve real property, in the states. Some states may follow the new rules at the state level. Others may partially follow. Other states may reject or “decouple” from the federal rules. Stay tuned to the states and local taxing jurisdictions that have coverage of your business activities, as an entirely new set of state and local tax issues evolve. The states will act, or react, and some may overreact to federal tax law changes.

CAUSE FOR HOPE

The overall circumstance that the renewable energy sector finds itself in because of tax reform has created new challenges. However, the general viewpoint held by many on both the domestic and global fronts remains positive.

The demand for projects, the entrance of new investors into the U.S. market, and the growing corporate demand for renewables as a function of corporate responsibility and global stewardship continues to assure an increasing systemic interest in renewable energy investment. This positivism appears to persist despite increased pressure on the sector by trade tariffs and other head-winds. Fortunately, both the wind and solar sectors have always thrived under pressures imposed by U.S. law an energy policy.

This is part two of a two-part series. In part one, we discussed the Beat and the impact of the Tax Cuts and Jobs Act on renewable energy as well as explicitly within the solar and wind sectors.

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