Key Energy-Related Tax Provisions in the 2017 Budget Proposal

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As in previous proposed budgets, President Obama's recently released budget proposal for the 2017 fiscal year contains energy-related tax provisions that include a permanent extension of the renewable energy production tax credit (PTC) and a provision making it refundable. Making the PTC permanent and refundable signals the administration's continued strong support for renewable energy.

The Obama administration's budget proposal (Proposal) affects several energy-related tax provisions, many of which were also included in the revenue proposals from past years. However, there are two key differences from past proposals. Past proposals called for the permanent extension of the research and experimentation (R&E) credit and section 179 expensing. Last year, Congress made the R&E credit and section 179 expensing permanent. For more information, see McDermott's analyses of energy tax proposals in the 2011, 2012, 2013, 2014, 2015 and 2016 proposed budgets.

This *On the Subject* summarizes the key energy-related tax provisions contained in the Proposal and detailed further in the US Department of the Treasury's general explanation of the Proposal (Green Book).

Modify and Permanently Extend the Production Tax Credit

Last year, Congress enacted multi-year extensions of the PTC under section 45 of the Code for qualifying renewable energy facilities, such as wind, solar, biomass, geothermal, landfill gas, municipal solid waste, hydroelectric, and marine and hydrokinetic facilities. To qualify for the PTC, construction of the qualifying facility for qualifying renewable energy resources (other than wind) must begin before January 1, 2017. For wind facilities to qualify for the PTC, construction of a qualifying facility must begin before January 1, 2020. However, the PTC for wind facilities phases out beginning in 2017. For wind facilities the construction of which begins after December 31, 2016, and before January 1, 2018, the PTC is reduced by 20 percent. For wind facilities the construction of which begins after December 31, 2017, and before January 1, 2019, the PTC is reduced by 40 percent. For wind facilities the construction of which begins after December 31, 2018, and before January 1, 2020, the PTC is reduced by 60 percent.

Congress also extended the investment tax credit (ITC) under section 48 of the Code for solar projects through 2022. For solar facilities, the ITC is reduced beginning in 2020, and is reduced to 10 percent for projects the construction of which begins before 2022 but which are not placed in service before 2024. In addition, qualified wind facilities may elect to claim the ITC in lieu of the PTC for facilities on which construction begins before January 1, 2020. For wind facilities, the ITC also phases out beginning in 2017 under the same phase-out schedule as for the PTC. For all other qualified facilities, the election to claim the ITC in lieu of the PTC must be made for facilities on which construction begins before January 1, 2017. Click here for more information on the extension of the PTC and the ITC.

The PTC is a credit per kilowatt-hour of electricity produced from qualified energy facilities. The base amount of the PTC (indexed annually for inflation) is 1.5 cents per kilowatt hour of electricity produced from wind, closed-loop biomass, geothermal energy and solar energy, and 0.75 cents per kilowatt hour for electricity produced in open-loop biomass, small irrigation power, landfill gas, trash, qualified hydropower, and marine and hydrokinetic renewable energy facilities. In 2015, the credit was 2.3 cents per kilowatt hour for qualified resources in the first group and 1.2 cents per kilowatt hour for qualified resources in the second group.

The Proposal would permanently extend the PTC at current credit rates (adjusted annually for inflation) and would make the PTC refundable. Many renewable energy developers are new, growing firms that have insufficient tax liability to claim the PTC. As a result, these developers enter into joint ventures or other financing transactions with other parties to take advantage of the PTC. Making the PTC refundable might reduce transaction costs for developers, further incentivizing the production of renewable energy. The Proposal would also allow the PTC for solar facilities that qualify for the ITC and on which construction begins after December 31, 2016.

In addition to extending the general PTC, the Proposal would extend the credit to electricity consumed directly by the producer to the extent that the production can be independently verified. The Proposal would also allow individuals to claim the PTC for energy-efficient solar property installed on a residential dwelling unit before January 1, 2022, in lieu of the residential energy-efficient property tax credit under section 25D of the Code. The current energy-efficient property tax credit was extended by Congress last year and applies to residential solar systems placed in service before January 1, 2022, subject to the same phase-out schedule as the ITC. Individuals who install solar property on a dwelling unit after December 31, 2021, may claim only the PTC.

Under the Proposal, the ITC would also be permanently extended based on the availability of the credit under current law in 2017. The ITC currently provides a 30 percent credit for solar, fuel cell and small wind property, and a 10 percent credit for geothermal, micro turbine, and combined heat and power property placed in service by December 31, 2016 (December 31, 2021, for solar projects). However, beginning in 2017, the ITC for wind will be phased out and reduced by 20 percent. Thus, the Proposal would provide for a permanently reduced ITC for wind projects. The Proposal would make those credits permanent and would also make permanent the election to claim the ITC in lieu of the PTC for qualified facilities eligible for the PTC.

Enhance and Simplify the Research and Experimentation Tax Credit

Last year, Congress reinstated the R&E credit pursuant to section 41 of the Code retroactive to amounts paid or incurred during calendar year 2015, and made the credit permanent. The R&E credit had expired on December 31, 2014. The R&E "traditional" tax credit equals 20 percent of eligible costs for qualified research expenses above a base amount. The base amount is generally computed by looking at the ratio of the taxpayer's research expenses to its gross receipts for past periods. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year.

Taxpayers can also elect the alternative simplified research credit (ASC), which is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. Under the ASC, the rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any of the three preceding taxable years. An election to use the ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary.

Qualified research expenses include both in-house research expenses and contract research expenses. Generally, only 65 percent of payments for qualified research by the taxpayer to an outside person is included as contract research expenses, except that in the case of payments to a qualified research consortium, 75 percent of the payments is included.

The R&E credit is a component of the general business credit under section 38 of the Code, but the R&E credit is not allowed to offset alternative minimum tax (AMT) liability, unless the taxpayer qualifies as an eligible small business. A qualified small business may also elect to claim up to $250,000 of R&E credit as a payroll tax credit against its employer share of Social Security old age, survivors and disability insurance taxes. In addition, section 41(g) of the

Code provides a special rule for owners of a pass-through entity, that limits the amount of the R&E credit to the amount of tax attributable to that portion of a person's taxable income that is allocable or apportionable to the person's interest in such trade or business or entity. Furthermore, although R&E costs are generally deductible in the taxable year in which they are paid or incurred, business owners of pass-through entities who do not materially participate in the conduct of a trade or business must capitalize and amortize R&E costs over 10 years when calculating AMT for individuals.

As explained in the Green Book, the Proposal would repeal the traditional method and would make the following changes:

- Increase the rate of the ASC from 14 percent to 18 percent
- Eliminate the reduced ASC rate of 6 percent for businesses without qualified research expenses in the prior three years
- Allow the R&E credit to offset the AMT liability for all taxpayers
- Provide that contract research expenses would include 75 percent of payments to qualified nonprofit organizations (such as educational institutions) for qualified research
- Repeal the special rule for owners of a pass-through entity

The Proposal would also repeal the requirement that R&E costs be amortized over 10 years when calculating the individual AMT. These changes would apply to expenditures paid or incurred after December 31, 2016.

Provide Carbon Dioxide Investment and Sequestration Tax Credits

Under current law, a $20 credit is allowed for every qualified metric ton of carbon dioxide (CO_2) that is captured at a qualified facility and disposed of in secure geological storage. The credit is $10 per metric ton if the CO_2 is used as a tertiary injectant in an enhanced oil or natural gas recovery. Credits will be allowed until 75 million metric tons of qualified CO_2 have been sequestered.

The Proposal would allocate $2 billion as a new refundable investment tax credit to projects that capture and permanently sequester CO_2. Credits would be available for investments in new and retrofitted electric generating units. Projects must capture and store at least one million metric tons of CO_2 per year. Projects that treat the entire flue gas stream from an electric generating unit or set of units must sequester at least 50 percent of the CO_2 in the stream. Projects that treat only a portion of the flue gas stream must capture at least 80 percent of the CO_2 stream.

The investment credit would equal 30 percent of the installed cost of eligible property, which includes CO_2 transportation and storage infrastructure, such as pipelines, wells and monitoring systems. Eligible property includes only property that is part of a new project or retrofit placed in service after December 31, 2015. Eligible taxpayers must apply for the credit within two years after enactment, and taxpayers would be able to apply an investment credit to part of or all of the qualified investment in the project. The Secretary of the Treasury would award credits based upon the following two considerations: (1) the credit per ton of net sequestration capability, and (2) the expected contribution of the technology and plant to the long-run viability of carbon sequestration from fossil fuel combustion. In allocating credits, the Secretary would statutorily be required to allocate no more than $800 million of the credits to projects that capture and store less than 80 percent of their CO_2 emissions. At least 70 percent of the credits would be required to be allocated to projects fueled by more than 75 percent coal.

In addition to the investment credit, the Proposal would allow a new refundable sequestration tax credit for qualified investments. For CO_2 permanently sequestered and not beneficially reused, the credit would be $50 per metric ton, and for CO_2 permanently sequestered but beneficially reused, the credit would be $10 per metric ton. The credit would be indexed for inflation and allowed for a maximum of 20 years of production.

Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualified Advanced Energy Manufacturing Project

Currently, a 30 percent tax credit is provided for investments in eligible property used in a "qualifying advanced energy project" pursuant to section 48C of the Code. A qualifying advanced energy project is a project that re-equips, expands or establishes a manufacturing facility for the production of the following:

- Property designed to produce energy from renewable resources
- Fuel cells, micro turbines or an energy storage system for use with electric or hybrid-electric vehicles
- Electric grids to support the transmission, including storage, of intermittent sources of renewable energy
- Property designed to capture and sequester carbon dioxide emissions
- Property designed to refine or blend renewable fuels or to produce energy conservation technologies
- Electric drive motor vehicles that qualify for tax credits, or components designed for use with such vehicles
- Other advanced energy property designed to reduce greenhouse gas emissions

Eligible property is property (1) that is necessary for the production of a qualified advanced energy project, (2) that is tangible personal property or other tangible property (not including a building and its structural components) that is used as an integral part of a qualifying facility, and (3) with respect to which depreciation (or amortization) is allowable.

Under the American Recovery and Reinvestment Act of 2009, total credits were capped at $2.3 billion, resulting in the funding of less than one-third of the technically acceptable applications that have been received. The Proposal would authorize an additional $2.5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. Up to $200 million may be allocated to infrastructure projects that contribute to the network of refueling stations for alternative fuel vehicles. Taxpayers would be able to apply for a credit with respect to part or all of their qualified investment. If a taxpayer applies for a credit with respect to only part of the qualified investment in the project, the taxpayer's increased cost sharing and the project's reduced revenue cost to the government would be taken into account in determining whether to allocate credits to the project.

Applications for the additional credits would be made during the two-year period beginning on the date on which the additional authorization is enacted. Applicants allocated additional credits would have to show that the requirements of the certification had been met within one year of the date of acceptance of the application, and would have to place the property in service within three years from the date of the issuance of the certification.

Enhance and Make Permanent the New Markets Tax Credit

The new markets tax credit (NMTC) program pursuant to section 45D of the Code is a credit taken over seven years and is generally equal to 5 percent of the amount of the taxpayer's qualified investment for the first three years, and 6 percent of such investment for the last four years (for a total credit of 39 percent). The NMTC is available to offset regular federal income tax liability but cannot be used to offset AMT liability. Last year, Congress extended the NMTC through December 31, 2019.

The Proposal would permanently extend the NMTC and authorize the NMTC allocations with an allocation amount of $5 billion for each year after 2019. The Proposal also would permit NMTC amounts resulting from qualified investments made after December 31, 2019, to offset a taxpayer's AMT liability.

The Proposal would be effective after December 31, 2019.

Provide New Manufacturing Communities Tax Credit

Currently there is no tax incentive directly targeted at investments in communities that do not necessarily qualify as low-income communities, but which have suffered or expect to suffer an economic disruption as a result of a major job loss event, such as a military base or manufacturing plant closing. The Proposal includes a new allocated tax credit to support investments in communities that have suffered a major job loss event. For this purpose, a major job loss event occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit, resulting in a long-term mass layoff.

Applicants for the credit would be required to consult with relevant state or local economic development agencies (or similar entities) in selecting those investments that qualify for the credit. This credit could be structured similarly to the NMTC or as an allocated investment credit similar to the qualifying advanced energy project credit. The Proposal would

provide about $2 billion in credits for qualified investments approved in each of the three years, 2017 through 2019.

Extend the Tax Credit for Second Generation Biofuel Production

In 2013, the "cellulosic biofuel producer credit" was renamed the "second generation biofuel producer credit." The credit is a nonrefundable credit of $1.01 for each gallon of qualified second generation biofuel produced in the taxable year. Second generation biofuel includes any liquid fuel that (1) is produced in the United States and used as fuel in the United States; (2) is derived from fiber-based sources (lignocellulosic or hemicellulosic matter) available on a renewable or recurring basis, or from cultivated algae or related microorganisms; and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act. Second generation biofuel cannot qualify as biodiesel, renewable diesel or alternative fuel for the credits relating to those fuels. This credit will expire on December 31, 2016.

The Proposal would extend the $1.01 per gallon credit through December 31, 2022, and would then reduce the amount of the credit by 20.2 cents per gallon in each subsequent year, so that the credit would expire after December 31, 2026.

Impose an Oil Fee

Currently, oil and refined petroleum products are subject to several excise taxes. The Oil Spill Liability Trust Fund excise tax is 8 cents per barrel before January 1, 2017, and 9 cents per barrel after January 1, 2017. A motor vehicle fuel tax is imposed on gasoline and diesel fuels—18.4 cents per gallon for gasoline (other than aviation gasoline) and 24.2 cents per gallon for diesel fuel or kerosene. Excise taxes on aviation fuel are 4.4 cents per gallon for commercial aviation fuel and 21.9 cents per gallon for non-commercial aviation fuel. An additional 14.1 cents per gallon surtax applies on general aviation fuel purchased and used in certain fractionally owned aircraft through September 30, 2021. There is also an excise tax of 29 cents per gallon on any liquid used as a fuel in a vessel in commercial waterway transportation.

To support critical infrastructure, fund investments in a cleaner transportation system, improve climate resiliency needs and reduce carbon emissions by shifting the market towards more sustainable technologies, the Proposal would impose a fee on a per barrel equivalent of crude oil. The fee would be collected on both domestically produced and imported petroleum products. Exported petroleum products would not be subject to the fee, and home heating oil would be temporarily exempted. The fee would be $10.25 per barrel (adjusted for inflation from 2016) and would be phased in evenly over a five-year period beginning October 1, 2016. The fee would be fully phased in beginning October 1, 2021.

Require Derivative Contracts to Be Marked to Market with Resulting Gain or Loss Treated as Ordinary Gain

Currently, derivative contracts are subject to the rules on timing and character depending on how the contract is characterized and, in some cases, where it is traded. The Proposal would require that derivative contracts be "marked to market"—*i.e.*, that gain or loss from a derivative contract be reported on an annual basis as if the contract were sold for its fair market value no later than the last business day of the taxpayer's taxable year. Gain or loss from such contract would be treated as ordinary and attributable to the taxpayer's trade or business. The source of income associated with the derivative contract would continue to be determined under current law. However, transactions that qualify as business hedging transactions would not be required to be marked to market.

The Proposal would broadly define a derivative contract to include any contract, the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property, and any contract with respect to a contract previously described. Under this broad definition, mark to market treatment would apply to contingent debt and structured notes linked to actively traded property. The gain or loss from a derivative contract would be required to be marked to market no later than the last business day of the taxpayer's taxable year and would be treated as ordinary.

The Proposal would eliminate or amend a number of Code provisions. Code section 475 (regarding mark to market accounting method for dealers in securities) would be amended, and Code sections 1256 (regarding marked to market treatment as 60 percent long-term capital gain or loss

and 40 percent short-term capital gain or loss) and 1092 (tax straddles) would be eliminated. In addition, the application of Code sections 1233 (short sales), 1234 (gain or loss from an option), 1234A (gains or losses from certain terminations), 1258 (conversion transactions), 1259 (constructive sales transactions) and 1260 (constructive ownership transactions) would be significantly curtailed.

The Proposal would apply to derivative contracts entered into after December 31, 2016.

Elimination of Fossil Fuel Preferences

The Proposal's expenditures are to be funded in part by the elimination of many of the fossil fuel preferences under the Code. Specifically, the Proposal would take the following actions, among others:

- Repeal the enhanced oil recovery credit.
- Repeal the credit for oil and gas produced from marginal wells.
- Repeal expensing for intangible drilling costs.
- Repeal the deduction for qualified tertiary injectant expenses.
- Repeal the exception to the passive loss limitation for working interests in oil and natural gas properties.
- Repeal percentage depletion for oil and natural gas wells. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in oil and gas wells. A similar proposal would apply to coal and hard mineral fossil fuel production.
- Repeal the ability to claim the domestic production manufacturing deduction against income derived from the oil and gas production.
- Increase the geological and geophysical amortization period from two years to seven years for independent oil and gas producers.
- Repeal expensing, 60-month and 10-year amortization for exploration and development costs relating to coal and other hard-mineral fossil fuels. The costs would be capitalized as depreciable or depletable property, depending on the nature of the costs incurred, in accordance with the generally applicable rules.
- Repeal percentage depletion for hard mineral fossil fuels.
- Repeal capital gains treatment of coal and lignite royalties in favor of taxing those royalties as ordinary income.
- Repeal the ability to claim the domestic manufacturing deduction against income derived from the production of coal and other hard mineral fossil fuels.

The elimination of these preferences for fossil fuel would be effective for production or for costs incurred after December 31, 2016, and, in the case of royalties, for amounts realized after taxable years beginning December 31, 2016.

The Proposal also would repeal the corporate income tax exemption for publicly traded partnerships (*i.e.*, master limited partnerships) with qualifying income and gains from activities relating to fossil fuels for tax years beginning after December 31, 2021.

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