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Client Alert Commentary

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Tax Reform Update — Impact on Renewable and Energy Projects

Major tax overhaul will reshape the renewables and energy industries.

Key Points:

- Sponsors must navigate new tax rules in search of lowest after-tax capital structures.
- A new cross-border tax threatens to complicate the tax equity market.
- Industry faces changes to more than a dozen key tax provisions.
- New and used energy assets are eligible for full expensing.

The conference committee released the final text of its compromise tax reform bill late on Friday. The bill has been passed by both the House and the Senate, and is expected to be signed into law by President Trump later this week.

The bill puts to rest many of the fears expressed by the renewable energy industry, but leaves uncertain how the broader tax equity market will adapt to the new rules.

A number of provisions in the bill will increase the after-tax returns available to project owners, including a lower corporate and pass-through tax rate, and a broad provision allowing all new and most used assets to qualify for an immediate 100% write-off.

Other parts of the tax bill cut the other way. Owners of heavily leveraged projects will now face new limits on the deductibility of interest and the use of net operating losses, while large multinational investors will need to consider the impact of a new base erosion anti-abuse tax (BEAT) on the value of the tax benefits generated by project investments.

The new tax rules will usher in a new set of market conditions, as sponsors and investors reassess how best to optimize capital structures in search of the lowest after-tax cost of capital. These rules may also cause renewable and energy assets to migrate to new owners who are better equipped to adapt to the new tax regime. The variables at play will include whether to hold assets in corporate or pass-through entities; how best to capitalize projects through a combination of equity, debt, and tax equity; and how to allocate a new subset of risks relating to the uncertain future value of tax credits among buyers, sellers, and tax equity investors.

On balance, the renewable energy industry avoided most of the proposals that would have dramatically affected the market. Proposals to retain the corporate alternative minimum tax (AMT) while reducing the regular corporate tax and to reduce production tax credits by one-third and to codify a potentially stricter start of construction rule, were all eliminated in the final bill. The BEAT provision, first proposed by the Senate in a form that would have eviscerated the value of renewable tax credits for many market participants, was significantly scaled back in the final bill, albeit temporarily. The BEAT rules now generally limit the tax claw-back to only 20% of the value of production and investment tax credits through 2025. Each potential tax equity provider will now have to calculate the effect of this claw-back on its future ability to realize the after-tax value of any tax equity investments.

Latham & Watkins has published additional materials analyzing the tax reform legislation and will continue to provide resources, including worthwhile third-party content, and insights through the Latham & Watkins US Tax Reform Resource Center.

Tax Credits

Tax credits for wind and solar projects are unaffected by the new bill. The production tax credit retains its current phase-out period for wind projects that begin construction by the end of 2019. Current Internal Revenue Service (IRS) guidelines that outline the requirements for starting construction remain in effect. Solar tax credits remain at 30% for projects under construction by the end of 2019 with a gradual phase-down to 10% for projects that begin construction in 2020, 2021, or 2022.

Corporate Tax Rate

The bill reduces the corporate tax rate from 35% to 21% starting in 2018.

A lower tax rate will reduce the value of tax deductions and correspondingly increase the cost of tax equity. Most tax equity transactions calculate the investor's return by referencing an after-tax internal rate of return that will now attribute less value to tax depreciation deductions. Consequently, the renewable energy industry could see a number of effects from this change. First, and most obvious, a lower corporate tax rate may reduce the number of tax equity investors interested in financing renewable energy projects. Corporate investors may have less tax liability to shield, or may be unable to fully realize the value of the tax shield generated by the investment due to the BEAT tax or other limitations.

Second, tax equity transactions that have already closed may contain contractual provisions requiring immediate adjustments to the economic terms of the arrangement to preserve the tax equity's expected return thresholds. Those arrangements that don't have immediate adjustments will likely still require larger shares of operating cash flow to be distributed to the tax equity if its return thresholds are unmet after a prescribed period of time, such as an "expected flip date." This may impact the amount of cash flow available to service debt on back-leveraged loans or to pay equity distributions on mezzanine or other "upper-tier" investments. A lower tax rate should have minimal impact (or in some cases even benefit) those transactions that are further along and have exhausted all or most of the tax deductions from the project.

Third, tax equity transactions that have not yet closed, including those with outstanding debt and/or tax equity commitments, may need to resize the cost and availability of tax equity. A reduction in the size of the equity commitment may impact the sizing of the debt commitment, a portion of which typically bridges the tax equity investment.

As tax rates are not scheduled to drop under the bill until 2018, accelerating tax deductions into 2017 when the tax rate is still 35% may become an important tool in maximizing the value of these deductions, thereby mitigating shortfalls in the amount of tax equity. Many debt and tax equity financings signed up since the 2016 election have been sized on the assumption that tax rates would go down.

100% Bonus Depreciation

Almost all investment property is eligible for a 100% bonus depreciation under the new bill. This would mark a significant change from current law, which allows for a 50% bonus depreciation deduction for investment property placed in service in 2017; a 40% bonus depreciation deduction for 2018 property; and a 30% bonus depreciation deduction for 2019 property.

In a big change from current law, the bill's 100% bonus depreciation deduction would apply to both new and used property that a taxpayer acquires and places in service after September 27, 2017 and before the end of 2022. Starting in 2023, 100% bonus depreciation will phase-down by 20% per year, until it is fully eliminated at the end of 2026. Assets that are acquired or placed in service before September 28, 2017 generally will continue to be subject to the current bonus depreciation rules described above.

Regulated utilities and certain real estate businesses generally are not eligible for the new bonus depreciation. Private equity and infrastructure funds with tax-exempt investors may lose some portion of the bonus subsidy, depending on how the tax-exempt investors hold their interest in the fund or the particular fund vehicle.

Used property is not eligible for bonus depreciation if it is acquired from a related party or if it is acquired in a tax-free transaction, such as a contribution to a partnership. A buyer is generally related to a seller if they are part of the same corporate group or if there is 50% or greater overlapping ownership among the two. Additionally, any sale must be at arm's length, likely increasing the importance of an independent valuation report to support the purchase price.

Determining the date on which property is "acquired" will become important when applying the new bonus rules. Property is acquired no later than when a binding written contract is first put in place to buy the property. Each turbine in a wind farm should be tested separately under this standard. A special rule may allow taxpayers to consider a wind turbine as "acquired" no earlier than when it has incurred 10% of the costs of the turbine.

The bill allows taxpayers to elect out of the bonus depreciation and instead apply the regular depreciation schedule. Alternatively, under the bill, taxpayers generally may elect to claim 50% bonus depreciation under the current rules for property placed in service during the remainder of 2017.

In anticipation of a reduced corporate tax rate, many renewable energy projects have been taking advantage of the 50% bonus depreciation under current law to increase the value of tax benefits transferred to tax equity investors. The larger 100% bonus depreciation may be too large of a deduction for tax equity investors to use under partnership tax rules. A tax equity investor generally is not permitted to claim deductions that exceed its capital investment, unless the investor agrees to future capital call obligations in the form of a deficit restoration obligation. Even then, tax deductions that exceed the tax equity investor's tax basis in its investment are deferred until later in the deal, making them less valuable than deductions that can be immediately claimed and utilized.

Project owners may be able to best monetize these new, larger tax benefits by using sale-leaseback structures rather than the more common partnership tax equity structures. In a sale-leaseback structure, an investor who can better use the tax benefits purchases and then leases the asset back to the seller. The value of the tax benefits is used to subsidize the financing rate under the lease. This structure may widely benefit a broad range of assets in the power and renewables sector. A sale-leaseback may also be beneficial to highly leveraged companies that are capped out of the interest deductions they may claim under the new rules described below. Substituting rental expense for interest deductions may be the most optimal after-tax capital structure for these companies.

BEAT

The BEAT tax is a new minimum tax designed to limit large multinational companies from reducing their US tax liability by claiming deductions for payments made to foreign affiliates. A taxpayer will have to pay the BEAT tax in any year it exceeds the taxpayer's regular tax liability otherwise owed in that year. While the BEAT tax is not aimed at the renewable energy industry or renewable energy tax credits, the BEAT tax may affect the value of tax credits to multinational banks and other corporations that invest in renewable energy projects if the investor is unable to offset its BEAT tax liability with renewable energy tax credits. Under the bill, only 80% of the value of renewable energy tax credits may be used against the BEAT tax in each year through 2025. After 2025, none of the renewable energy tax credits may be used against a taxpayer's BEAT tax liability.

How much this will matter to tax equity investors will depend on whether the tax equity investor anticipates being subject to the BEAT tax in any year in which it plans to claim tax credits, and how much BEAT tax it projects it will have to pay in each of those years. This computation depends on a myriad of factors and future transactions and, for most investors, will be difficult to project with accuracy.

The BEAT applies only to: a) large corporations with average annual gross receipts over the past three years of at least US$500 million, and b) corporations that take deductions for cross-border payments that are equal to at least 3% of the corporation's total deductions for that year (2% for banks). Many large banks will be subject to the BEAT tax because they make large payments to foreign affiliates for services and to pay interest on borrowings.

Companies subject to the BEAT tax will have to calculate their BEAT tax liability and regular tax liability each year and then pay whichever one is higher.

The BEAT tax is calculated as a percentage of a modified, higher tax base, determined by disallowing all deductions that are generated by payments to foreign affiliates unless the payments are subject to US withholding tax or come within certain exceptions for cross-border derivative payments and cost-based service payments. The BEAT tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and thereafter. The rates are 1% higher in each year for banks. If a taxpayer's BEAT tax liability is less than its regular tax liability, the taxpayer pays its regular tax liability. If a taxpayer's BEAT tax liability exceeds its regular tax liability, the taxpayer pays its regular tax liability plus the difference between its BEAT tax liability and its regular tax liability. The higher the BEAT tax rate, the more likely the BEAT tax will exceed a taxpayer's regular tax liability given the higher tax base.

Many large companies reduce their regular tax liability through the use of tax credits, including renewable energy tax credits. For those companies that are subject to the BEAT tax, there is no value in reducing their regular tax liability below their BEAT tax liability through the use of renewable energy tax credits because the higher BEAT tax would nullify the effect of any reduction.

The bill temporarily "fixes" this problem by allowing up to 80% of the renewable energy tax credits to be claimed against the BEAT tax through 2025. The fix may not be enough for tax equity investors to fully value tax credits in current transactions.

Some investors may still project that they will lose up to 20% of the tax credit value in any given year. There is no carryforward for tax credits that cannot be used to offset the BEAT tax. Also, unless the law is changed in the future, the value of all tax credits may be lost starting in 2026, when no part of the renewable energy tax credits may be used to offset the BEAT tax and the BEAT tax rate will be at its highest level.

It is not yet clear how the tax equity market will solve this issue. Some transactions may be structured with shorter "flip" tenors, so that the investors limit exposure to tax credits generated after 2025. Others may migrate to pay-go structures in which tax credits are monetized based on the facts at the time the credits are generated. Changing the risk allocations around the BEAT tax will likely ripple through a project's capital structure, putting increased pressure on construction loan take-out commitments and back-leverage sizing and pricing metrics.

Limitations on Interest Deductions

Starting in 2018, the bill limits the amount of interest that can be deducted in any year to 30% of a borrower's taxable income, increased for depreciation and amortization deductions for tax years that end before 2022. After 2022, depreciation and amortization deductions are required to be taken into account, which will have the effect of reducing taxable income and increasing the likelihood that the limitation will apply. Any interest that cannot be deducted on account of this limitation may be carried forward indefinitely to future taxable years.

This limitation applies both at the corporate level and to each partnership that pays interest under a loan.

If the limitation applies to a partnership, the interest is not deductible until future income is earned by that partnership.

This limitation may affect the after-tax returns of projects that are highly leveraged, especially those that are held in partnership form. Project sponsors with significant project leverage may choose to replace debt with other forms of capital, such as preferred equity or lease equity to avoid these limitations. Project sponsors may also consider aggregating multiple projects or portfolios into one partnership in an effort to increase taxable income and the corresponding interest limitation.

NOL Carryforwards

Under the new bill, net operating losses (NOLs) may now be carried forward indefinitely to future tax years, but they may no longer be carried back to previous tax years. Going forward, NOL carryforwards may only be used against 80% of a corporation's regular taxable income. This limitation is similar to (although less favorable than) the limitation under the current corporate AMT rules being repealed, which only allowed NOL carryforwards to offset 90% of a corporation's alternative minimum taxable income.

Repeal of Partnership Technical Terminations

Starting in 2018, the bill would repeal the existing rule that treats a partnership as "terminating" when 50% or more of the capital and profits interest of a partnership are sold or exchanged within a 12-month period.

Under current rules, a terminating partnership forfeits all of its existing elections and must restart its depreciation periods after the deemed termination. Restarting depreciation effectively stretches out the remaining tax depreciation, decreasing the present value of the remaining tax depreciation. Most tax equity agreements prohibit a termination unless an indemnity is paid to existing partners to compensate them for a slower depreciation schedule.

Recently, partnership terminations have proved to be a useful planning tool for maximizing the value of bonus depreciation in tax equity transactions. In these transactions, sponsors hold wind projects in partnerships before the tax equity funds its commitment and the tax equity funding is structured to result in a termination of the existing partnership. Under a special tax rule, the new partnership deemed created between the sponsors and the tax equity is then entitled to claim all the bonus depreciation available in the funding year.

The repeal of the partnership termination rules coupled with the new 100% bonus depreciation rules applicable to new and used property may give rise to new structures that seek to optimize the tax benefits in renewable and energy projects.

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