ASSESSING THE IMPACT

Will The Tax Cuts Act Cut Back AD?

The Act signed into law in late December is better than many forecast — but the jury's still out regarding the effects on anaerobic digestion and other renewable energy projects.

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DESPITE fear and trembling across the industry as the "Tax Cuts and Jobs Bill" (H.R.1, P.L. 115-97) sped towards Presidential signature December 22, the results seem both mixed and better than expected for renewable energy projects. The Act bears good news and bad news for project developers. But its main message may be a big blinking "caution" light, for existing as well as new projects.

The Act was so hurriedly written — Senate Republicans announced they "had the votes" before the Senate bill was drafted — that its full implications may not be clear for months. Its uncertainties will be magnified by the limited ability of an underfunded Internal Revenue Service to play catch-up through clarifying guidance. In addition, it mostly became effective January 1, 2018, without the usual transition regimes that allow affected parties planning time to cushion new tax effects.

Many of those effects are not obvious. They flow back and forth between widely separated Code provisions, echoing the First Earth Day slogan that "everything is connected to everything else." For anaerobic digestion (AD) projects specifically, the negatives of many Act provisions are mirror images of their positives.

What follows hits the highlights but necessarily skips many details.

GOOD NEWS

• **Existing tax credits are preserved**. The Act did not extend biomass-based electricity production tax credits (PTCs) whose current "begin construction" window expired December 31, 2016. It also did not address "orphan Investment Tax Credits (ITCs)" for biogas-related fuel cells, microturbines and combined heat and power (CHP) systems that were left out of the December 2015 PATH Act (see "Biomass-to-Electricity Tax Credits Extended," January 2016). But it left untouched all currently available PTCs and ITCs.

The House Bill would have permanently rolled back PTC value 40 percent to 1.5 cents/kWh from the current inflation-adjusted 2.4 cents/kWh. It also would have cut current ITC eligibility periods; eliminated the 4-year presumption that projects completed within that period are "continuously constructed"; and threatened to nullify the "financial safe harbor" for projects to qualify as having "begun construction."

The Senate declined to alter existing credits. It accordingly left in place project developers' ability to "look back" to 2016 and establish they "began construction" then. (See "Getting Renewable Energy Projects Done in Still Tougher Times," Feb. 2015.) It also left in place the $7,500 individual credit for purchase of plug-in electric vehicles — a market driver for AD or other biogas projects with outputs that may fuel electric or hybrid cars.

• **Projects can claim bigger deductions**. In general, the Act allows small businesses immediately to expense up to $1 million in qualified expenditures (including costs of modifications to use biogas or of new roofs to support solar panels) — a 33 percent increase (from $750,000 to $1 million). It also allows all businesses to claim 100 percent "bonus depreciation" in Year One on equipment purchased after September 27, 2017 and placed in service after January 1, 2018 (subject to a phase down of 20 percent for equipment placed in service during each year after 2022). The 100 percent figure represents a nominal doubling of the previous bonus depreciation deduction. Importantly, bonus depreciation now applies to arms' length purchases of used as well as new equipment. This may make project sales more attractive, as buyers

promptly may deduct most of an existing project's purchase price.

• **Corporate AMT is permanently repealed**. The Alternative Minimum Tax (AMT) was designed to capture revenue from companies that otherwise would pay little or no tax due to energy credits and other "tax preference" items. Its repeal frees up more investment capacity at tax equity investors like big banks and insurance companies. Repeal also removes some specific constraints on renewable energy projects, e.g., AMT applicability to PTCs after 4 years. Subjecting the last 6 years of the 10-year PTC payout to possible AMT "recapture" made these tax equity investments more uncertain and often resulted in "haircuts" in what investors pay projects to secure PTCs.

Especially for smaller developers, tax equity availability likely will shrink as providers focus on large projects or project portfolios they see as "lower risk."

• **Pass-through recipients get a permanent 20% holiday present**. AD and other renewable energy projects typically are structured as LLCs or similar "pass-through" entities. Starting this year, individuals receiving distributions from these entities may subtract 20 percent from their "qualified business income" (QBI) before calculating any taxes they owe. There were big battles over which entities should be eligible and how QBI should be defined, and the underlying computations are in flux. Still, individual project sponsors receiving less than $157,500 (single) or $315,000 (married) in a pertinent tax year generally should be able to subtract the full 20 percent. This "QBI bonus" is sometimes called the "super-199 deduction" because it replaces a previous Code Section 199 deduction for "domestic production activities" that broadly was available to renewable energy projects. That history may support developer arguments for broad "QBI bonus" availability.

• **Private activity bonds survived**. PABs have long been an important way for waste authorities and other state or local government bodies to finance AD-related nongovernment-owned infrastructure with flow through, low interest, nontaxable debt. The House Bill would have cancelled future state or local authority to issue federally nontaxable PABs. This generated an uproar from municipalities across the country. They also noted that repeal would undercut the Administration's infrastructure promises. The Senate rejected the House approach and authorized future PABs. But it compromised by prohibiting use of "refunding" bonds that allow state or local governments to substitute bonds with lower interest rates when rates decline. The compromise remains controversial.

BAD NEWS

• **The flat 21% corporate tax rate makes tax equity harder to get**. Unlike smaller graduated rate reductions for individual taxpayers, this reduction is permanent. It may benefit some existing projects structured as "flip" partnerships by accelerating the point at which these projects are "put back" to their developers. A lower tax rate means investors should reach that point more quickly. But it makes tax equity investments in new projects less attractive, because those investors generally will have less taxable income to offset with credits. Tax equity typically has provided about 30 percent of a project's "capital stack" when projects can secure it. The new lower rate is expected modestly to shrink the overall tax equity slice of that stack.

The flat rate's effect on developers' ability to monetize depreciation deductions may be far more severe. Only about 30 big financial corporations currently play in the tax equity sphere. To conserve their investment capacity and diversify it across more projects, they already were requiring many projects to forego previous 50 percent "bonus depreciation" and instead depreciate capital costs over 5 or more years. Many will view 100 percent depreciation more negatively.

• **Business interest deductions are capped**. Until this year all business-related interest generally was deductible. The Act limits annual business interest deductions to 30 percent of an entity's earnings before interest, taxes, depreciation and amortization (EBITDA), with more stringent caps after 2021. Because the underlying calculations are complex and open to manipulation, IRS rulings will be needed to clarify this provision. Meanwhile it seems likely to discourage both project construction debt, and "back-lever" debt often used to increase equity returns after a project has been completed.

• **NOLs are less useful**. Subject to certain limits, project net operating losses (NOLs) previously could be carried back to two previous tax years or carried forward 20 years, and deducted 100 percent against taxable income within these periods. "Carrybacks" could generate immediate tax rebates when applied to previous returns. "Carryforwards" could reduce future taxes. Thus NOLs offered potentially attractive tax assets to investors seeking to buy existing projects that carry "book losses." After 2017, the Act generally restricts NOL deductibility to 80 percent of an acquirer's taxable income. It also eliminates "carryback" ability to deduct NOLs. The 20-year deductibility of NOLs being carried forward apparently is not affected, even if they were incurred before 2018.

• **P-PAGs are eliminated**. Before the Act, prepaid power-purchase-agreements (P-PAGs) with certain government off-takers were a significant finance option. P-PAGs were a variation on relatively common municipal use of prepaid natural gas purchase agreements. In general, a municipal utility could agree to prepay (say) 70 percent of a project's 20-year deliveries and finance the prepayment through bonds issued at low tax-exempt rates. The lump sum prepayment could provide the project relatively cheap construction and long-term debt.

These prepay options now seem gone. The Act generally requires deferred gains — formerly reported only when actual deliveries are made — to be reported 100 percent as ordinary income within two years of when a purchase agreement is signed. For AD and other renewables developers, it converts possible P-PAG advantages to upfront tax liabilities.

• **Tax credit bonds are going away**. Qualified energy conservation bonds (QECBs) that repay their holders in federal tax credits rather than cash have been used by states to finance significant numbers of renewable energy projects, especially in rural areas. The Act terminates state/local authority to issue new QECBs, despite over $2 billion in QECB funding that's been appropriated but not yet been used.

• **The base erosion and anti-abuse tax ("BEAT") creates new uncertainties**. Of all the uproars as the bills moved through Congress, this may be Number One. To help limit to $1.5 trillion over 10 years the Act's projected add-on deficit, Congress sought to recapture "tax base" from cash transfers by domestic to overseas subsidiaries of multinational corporations. These transfers reduce U.S. taxes. The Act generally imposes a tax starting at 10 percent on them.

A substantial portion of tax equity comes from multinationals like J.P. Morgan Chase. The House Bill's BEAT formula would have treated these enti-

ties' tax credits as 100 percent taxable income — indirectly repealing their PTCs, their ITCs, and much tax equity financing. In a last minute frenzy, the Senate struck a compromise which taxes "only 20 percent" of providers' tax equity benefits. But it retained requirements that BEAT be calculated as of the end of each tax year, injecting pandemic planning uncertainty about whether or to what extent BEAT might apply as of Q2 or Q3 to reduce tax credits' expected annual value.

Tax equity providers promptly slowed their investment activities until they could analyze the impacts of the 20 percent reduction combined with these timing effects. The resulting market impact was encapsulated by the owner of a relatively small solar installer in Louisiana, who said in mid-January, "We just lost $100 million in tax equity last week. … We can't get past banks' credit committees anymore."

NET SHORT-TERM EFFECTS

• Especially for smaller developers, tax equity availability likely will shrink as providers focus on large projects or project portfolios they see as "lower risk." Hopes that new large tax equity players would expand the availability of tax equity did not materialize before the Act; new entrants will not be encouraged going forward.

• Project debt likely will be higher priced and more difficult to secure.

• AD and other renewable energy developers may be forced to pursue creative alternatives, e.g., private family offices, debt-like preferred equity that avoids the interest cap, or taxable bond financing.

• Some states may look to fill the federal financing gap, e.g., by providing refundable state tax credits or authorizing 100 percent deductible charitable contributions in lieu of state and local income taxes where deductibility by individual taxpayers now is capped at $10,000 per year. But most paths forward are cloudy right now.

COMING ATTRACTIONS

Nevertheless, the Act's full story is not written. Among other things:

• There's some pressure for a "technical corrections bill" to fix the Act's numerous ambiguities. Any such bill would require 60 Senate votes rather than a bare Republican majority. Eight years ago Republicans refused to consider a "tech-fix" bill to amend obvious problems in the Affordable Care Act. Senate Democrats may choose to repay that refusal by blocking technical corrections now. But if a tech-fix bill happens, some impacts above may be revisited.

• How (and when) the IRS will address issues raised by the Act remains open. There's enough precedent for career rule-writers trained in Code consistency to reach outcomes that either are favorable or unfavorable for AD. Whatever their instructions, they still will have to square new rulings with IRS decisions dating back decades.

• As Congress sent the Act to the White House the chair of the Senate tax writing committee introduced a bill (S. 2256) to extend both "orphan credits" and PTC/ITC or similar incentives for (e.g.) biomass and biogas-fuel projects. The proposed extensions generally would make benefits available to projects that "begin construction" before 2019, granting them a new 2- to 3-year eligibility window. It's unclear what may be needed to move this bill — repeal of the 1970s ban on exporting U.S. oil was the main trade-off for the 2015 extenders package. Still, the chair of the House tax writing committee has publicly promised to fix the "orphan credits" omission.

• "Permanent" does not necessarily mean "eternal." While the Act's corporate tax cuts facially are "permanent," its cuts for individual taxpayers generally expire in 8 years. Tax cut sponsors justified this disparity on grounds that a future Congress will restore taxpayer "parity" by making the individual provisions "permanent." But "parity" can work both ways. Faced with 10-year deficits exceeding $25 trillion, a new Congress or Administration may seek to reduce "permanent" cuts rather than Medicare, disease control or military-readiness programs. ■

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