McDermott Will & Emery

Key Energy-Related Tax Provisions in the 2016 Budget Proposal

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SPECIAL REPORT

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As in previous proposed budgets, President Obama's recently released budget proposal for the 2016 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 proposed in the revenue proposals from past years. For more information, see McDermott's analyses of the energy tax proposals in the 2011, 2012, 2013 and 2014 proposed budgets.

This *Special Report* offers a summary of the key energy-related tax provisions contained in the Proposal and discussed further in the U.S. Department of the Treasury's general explanation of the Proposal (Green Book).

Modify and Permanently Extend the Production Tax Credit

Last year, Congress extended the PTC under section 45 of the Code through the end of 2014 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 qualified facility must have begun before January 1, 2015.

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 2014, the credit was 2.3 cents per kilowatt hour for qualified resources in the first group and 1.1 cents per kilowatt hour for qualified resources in the second group.

The Proposal would permanently extend the PTC, and for facilities on which construction begins after December 31, 2015, the Proposal 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. By making the PTC refundable, transaction costs for developers will be reduced and incentives for producing renewable energy will be increased. The Proposal would also allow the PTC for solar facilities that qualify for the investment tax credit under section 48 of the Code (ITC) and for which construction begins after December 31, 2015.

In addition to 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 property installed on a residential dwelling unit. The current energy efficient property tax credit under section 25D of the Code would be allowed to expire at the end of 2016.

Under the Proposal, the ITC would also be permanently extended. The ITC provides a 30 percent credit for solar, fuel cell and small wind property placed in service by December 31, 2016, and a 10 percent credit for geothermal, microturbine, and combined heat and power property (and for solar and non-heat pump geothermal property placed in service after 2016). 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 Make Permanent the Research and Experimentation Tax Credit

The research and experimentation (R&E) credit pursuant to section 41 of the Code 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. An election to use the ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary.

As explained in the Green Book, the Proposal would make the R&E credit permanent, and, effective after December 31, 2015, would eliminate the traditional R&E credit but increase the rate of the ASC from 14 percent to 18 percent.

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 for investments in new and retrofitted electric generating units. New units, and the portions of retrofitted units to which the credit applied, would be required to capture more than 75 percent of their CO_2 emissions. The credit would only be available to retrofits that have capacities greater than 250 megawatts and that capture more than one million metric tons of CO_2 per year.

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 taxpayers must apply for the credit within 18 months after enactment. The Secretary of the Treasury would award credits based upon the following two considerations:

- The credit per ton of net sequestration capability
- Whether the technology and plant will contribute 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 60 percent to either new or retrofit projects and no more than 40 percent to any one technology category (*i.e.*, liquid solvents, solid sorbents, gas-separation membranes, warm gas clean-up, oxygen fired combustion systems and hybrid systems). 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. 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, microturbines 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

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 applied 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 must show that the requirements of the certification have been met within one year of the date of acceptance of the application and must 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 was available to offset regular federal income tax liability but could not be used to offset alternative minimum tax (AMT) liability. The NMTC expired on December 31, 2014.

The Proposal would permanently extend the NMTC and authorize the NMTC allocations with an allocation amount of $5 billion for each year. The Proposal also would permit NMTC amounts resulting from qualified investments made after December 31, 2014, to offset a taxpayer's AMT liability.

Provide New Manufacturing Communities Tax Credit

Currently there is no tax incentive directly targeted to 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 closing 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, 2016 through 2018.

Permanently Extend Section 179 Expensing

Section 179 of the Code provides that taxpayers may elect to deduct, rather than capitalize and depreciate, a limited amount of the cost of qualifying depreciable property placed in service during the taxable year. The deduction limit is reduced by the amount by which the cost of qualifying property placed in service during the year exceeds a threshold amount. The amount allowed as a deduction under section 179 cannot exceed the taxable income of the taxpayer.

Qualifying property generally is depreciable tangible property that is purchased for use in the active conduct of a trade or business. The definition of qualifying property currently includes real property and temporarily includes off-the-shelf computer software.

Beginning in 2007, the maximum deduction amount was $125,000, but this deduction amount was reduced by the amount that a taxpayer's investment exceeded $500,000. For 2008 and 2009, these thresholds were changed to $250,000 and $800,000, respectively, and for 2010 and 2011, these thresholds were $500,000 and $2 million, respectively. The American Taxpayer Relief Act of 2012 extended the threshold amounts for 2011 through 2013, and the Tax Increase Prevention Act of 2014 extended them through 2014. However, after 2014, these thresholds will revert to pre-2003 limits, *i.e.*, $25,000 and $200,000, respectively, with no indexing for inflation.

The Proposal would permanently extend the section 179 expensing and investment threshold limits for 2014—*i.e.*, a maximum deduction of $500,000, with an investment threshold limit of $2 million. For qualifying property placed in service in taxable years after December 31, 2015, the threshold limits will be increased to $1 million and $2 million, respectively, and would be indexed for inflation in taxable years beginning after December 31, 2016. The definition of qualifying property would permanently include off-the-shelf computer software but would not include real property.

The Proposal would be effective for qualifying property placed in service in taxable years beginning after December 31, 2014.

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. 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 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), and would significantly curtail 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).

The Proposal would apply to derivative contracts entered into after December 31, 2015.

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 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, 2015, and, in the case of royalties, for amounts realized after taxable years beginning December 31, 2015.

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, 2020.

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