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Client Alert
Commentary

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Impact of the House Tax Reform Bill on the Renewable Energy Sector

Bold proposal seeks changes to tax credits, depreciation, and corporate tax rates.

Key Points:

- Production Tax Credits are cut by more than one-third.
- Bill may impact existing and future tax equity arrangements.
- 100% bonus depreciation may push developers to sale-leaseback structures.
- Fuel cells and combined heat and power projects regain tax credit subsidies.

Overview

House Republicans unveiled a sweeping tax reform bill on Thursday, November 2 that proposed to lower the corporate tax rate and allow companies to immediately deduct the full cost of business assets in the year companies build or acquire them.

The bill also takes aim at some of the key tax subsidies that the wind industry uses. In particular, the bill proposes to cut about a third of the value of the production tax credits for wind projects that begin construction after the bill is enacted. The bill could also potentially overturn some important aspects of current Internal Revenue Service (IRS) rules that permit wind developers to claim tax credits on wind projects that had begun construction before 2017.

The proposal has less impact on the solar industry that relies on the investment tax credit.

If the bill is passed, the tax subsidy for solar projects will remain intact through the investment tax credit's current phase-down period. In addition, solar projects that begin construction before 2020 will remain eligible for a 30% investment tax credit. This tax credit will then gradually step down for projects beginning construction from 2020 through 2022 at the same rate that current law provides. However, the proposal calls for the investment tax credit to be entirely phased out for solar projects that begin construction after 2027, whereas under current law, those projects would have qualified for a permanent 10% credit.

The proposal also makes good on an earlier promise to extend the investment tax credit for some technologies that saw their tax subsidies eliminated at the end of 2016. These include small wind, combined heat and power and fuel cell projects. These projects would now qualify for the same investment tax credit as solar and disappear for projects that start construction after the end of 2021.

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This *Client Alert* addresses certain aspects of the bill that will interest the wind and solar industries, as well as the legislative process the bill faces going ahead. Latham & Watkins will soon publish additional materials analyzing the bill more broadly and other specific provisions in it.

Potential Timing

House Republicans are determined to move the bill quickly. They are hoping to debate and pass some version of the bill through the Ways and Means Committee this week and then vote it through the House in the next few weeks. In the meantime, Senate Republicans are also working on their own tax bill, which they expect to release soon for the Senate Finance Committee's markup and vote before the bill goes to a vote in the Senate. Industry groups and lobbyists will focus intently on the differences between the two bills. Those differences will have to be reconciled between House and Senate lawmakers before both houses of Congress can vote on a final version.

Republican lawmakers hope that the president will be able to sign the bill before the end of the year. Almost everything will have to go right for that to happen. Lobbyists for industries that are losing important tax breaks will fight hard to change or delay the bill as it moves through Congress. In order to pass under Senate rules, the bill needs to eliminate enough tax breaks to pay for most of the massive cut to the corporate tax rate, as well as other tax cuts that are important to many Republicans.

Key Proposal 1: Lower Corporate Tax Rates

As widely expected, the bill proposes to lower the corporate tax rate from 35% to 20% starting in 2018, at an expected cost of nearly US$1.5 trillion. Whether or not enough tax cuts can be found to pay for a rate reduction of this size remains to be seen.

A lower corporate tax rate may reduce the number of tax equity investors interested in financing renewable energy projects. There are still too many variables in play to determine if large corporations will have higher or lower overall tax liabilities if the bill were to pass into law. Some aspects of the bill would clearly reduce capacity for tax credits, such as lower tax rates, immediate deductions for investment property and limitations on net operating loss carryforwards. Others may increase the appetite for tax credits, such as new limitations on interest expense, minimum taxes on foreign earnings and the elimination of competing tax credits, such as the new markets tax credit.

Regardless, a lower tax rate would 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 attributes less value to tax depreciation deductions. Consequently, the renewable energy industry could see a number of effects as the proposal evolves.

First, 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.

Second, 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 tax

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 at 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.

Key Proposal 2: 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 from September 27, 2017 until the end of 2022. Property that regulated utilities and certain real estate businesses own would not be eligible for the new bonus depreciation. The bill allows taxpayers to elect out of the bonus depreciation and instead apply the regular depreciation schedule. Alternatively, under the bill, taxpayers may elect to claim 50% bonus depreciation for property placed in service during the remainder of 2017.

Many renewable energy developers 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 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 investment are deferred until later in the deal, making them less valuable than deductions that can be immediately claimed. Renewable energy developers and investors may therefore try to structure deals to qualify for the current bonus depreciation benefits, rather than the new, larger 100% bonus depreciation.

Companies may be able to best monetize these new, larger tax benefits by using sale-leaseback structures rather than partnerships, which currently are the most common form of 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.

Key Proposal 3: Changes to Tax Credits

Production Tax Credits

The bill proposes two important changes to the production tax credits for wind projects. First, the bill reduces the production tax credit by more than one third for any wind farm that begins construction after the bill's enactment. The bill implements this change by eliminating the inflation adjustment that has been used to increase the original value of the production tax credits that were set at US$0.015 per kw/h back in 1992 to the current value of US$0.024 per kw/h. Second, the bill modifies the current definition of "begun construction" to only apply to those wind farms that have maintained a "continuous program of construction." This change applies retroactively to wind farms that qualified for 100% of the production tax credit value by beginning construction before the end of 2016.

The bill proposes to re-trade the agreement made with the wind industry in 2015 that phased out the value of production tax credits over time. Under current law, production tax credits are phased down for

wind projects based on the date that construction first began on the project. Those wind projects that began construction before 2017 are eligible for 100% of the production tax credit. The production tax credit eligibility decreases for projects that begin in subsequent years: to 80% for those starting in 2017; 60% for those starting in 2018; and 40% for those starting in 2019. The reduction from US$0.024 to US$0.015 would apply in addition to the phase-out reduction. For example, a wind farm that begins construction in 2018 would qualify for 60% of the production credit value at a rate of US$0.015 per kw/h.

The meaning of "begun construction" has previously been left to the IRS, who defined it in a series of notices over the past few years. The IRS notices impose a continuity requirement on wind projects that begin construction, but only if they are not completed before the end of 2018, or in some cases, 4 years after construction first began. Projects that are completed in this timeline are safe harbored and presumed to satisfy any continuity requirement. The IRS required different continuity standards for projects completed outside the safe harbor, depending on the method used to qualify the project as being "under construction." For projects that began construction by commencing "physical work of a significant nature," the IRS required a continuous program of construction. For those that qualified by incurring at least 5% of the total cost of the project (*e.g.*, by buying at least 5% of the wind farm components), the IRS imposed a more liberal standard of continuity, known as the continuous efforts test.

Wind farm developers have made significant investments relying on those IRS rules. Some bought large amounts of turbines and others undertook significant physical work at the site of future projects or at the factories of their suppliers. It is not yet clear whether the bill proposes to overrule the IRS's previous announcements on this topic. While it is possible that Congress meant nothing more than to codify the existing administrative continuity requirement and defer to existing IRS rules for interpretation, the language in the bill introduces significant uncertainty into a large number of wind projects that are now in their development or early construction stages. It is no longer clear whether the bill allows those projects to rely on current IRS safe harbor rules or the more liberal continuous efforts requirement. Clarification on these topics is essential in order for a number of wind projects to remain economically viable.

Under current law, wind projects may elect to receive an investment tax credit instead of the production tax credit. Production tax credits are based on the project's energy production whereas the investment tax credit is based on the project's cost. During the past few years, as the cost of wind projects has dropped and the energy capacity from wind turbines has increased, most developers have opted for the production tax credits. The bill's proposed reduction to the production tax credits may cause some developers to reevaluate this choice for future projects.

The Investment Tax Credit

The investment tax credit for solar remains largely unchanged by the bill. Solar projects would remain eligible for the full value of the investment tax credit through 2019, and would then be phased out at the same pace as under current law. The permanent investment tax credit available to solar projects that start construction from 2022 onward would only apply to projects that have begun construction by the end of 2027.

A number of renewable energy technologies will regain tax subsidies that they lost at the end of 2016. Projects that use small wind, combined heat and power, or fuel cells would be eligible once again for the full investment tax credit if construction begins before 2020. Reduced tax credits would be available for those projects that start construction in 2020 and 2021.

The bill applies the same standards for "begun construction" to solar projects that are proposed to apply to wind projects. Projects will be considered "under construction" only if they maintain a continuous

program of construction from the applicable deadline. This last change will have little impact on the solar industry in the near term. Solar developers will have until the end of 2019 to gain further clarity on these new rules.

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