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JANUARY 2017 WWW.METROCORPCOUNSEL.COM

MCC INTERVIEW: Durham C. McCormick Jr. / McGuireWoods LLP

Without Tax Credits, Whither Renewables?

Climate change concerns drove a populist push to expand the use of renewables in the energy sector, and governments worldwide have largely incentivized the industry's expansion in recent years. The question is, would the loss of tax incentives take the wind out of the renewable energy industry's sails? We asked ***McGuireWoods*** *partner* ***Durham C. McCormick Jr.****, an expert in renewable energy tax credits, for guidance. His responses below have been edited for length and style.*

MCC: What federal and state tax incentives are currently available for renewable energy projects, particularly wind and solar?

McCormick: Renewable energy projects can qualify for a variety of federal and state incentives. The federal incentives are primarily focused on tax incentives, such as the investment tax credit (ITC) and the production tax credit (PTC). The PTC provides a 10-year tax credit based on the amount of energy sold by a renewable energy project, while the ITC provides a one-time tax credit based on the capitalized construction costs of a qualifying renewable energy project (typically 30 or 10 percent of the capitalized construction costs) and is claimed in the year the project begins commercial operation. Homeowners who install solar, wind or geothermal heat pumps on their home can also claim a 30 percent personal tax credit. The PTC and the ITC have aided development of commercial and utility-sized renewable energy projects, while the personal tax credit has helped in the growth of distributed solar generation.

Wind, biomass, geothermal, landfill gas, tidal and wave projects are some renewable energy projects that typically qualify for the PTC, while solar, geothermal, combined heat and power (CHP), and fuel cell projects are renewable energy projects that typically qualify for the ITC. Many technologies that qualify for the PTC can elect to claim the ITC instead. This is particularly helpful for geothermal or CHP projects that are allowed only a 10 percent ITC, but if they have begun construction by the end of 2016, they can elect to claim a 30 percent ITC in lieu of the PTC.

State tax incentives vary dramatically between jurisdictions. These incentives can range from property tax, sales tax and gross receipts tax exemptions to providing ITC- or PTC-type incentives. Many states (about 29 as of 2016) have also adopted renewable portfolio standards (RPS), which mandate that some or all of the utilities selling power within that state procure a certain percentage of their energy portfolio from renewable energy resources. California, for example, has a 33 percent RPS by 2020, increasing to 50 percent by 2030, while about 13 states have not adopted an RPS in any form. The other eight states currently have some form of a voluntary RPS.

MCC: How have these incentives, particularly the ITC and the PTC, helped stimulate investment in renewable energy projects?

McCormick: It is difficult to determine how any one incentive has positively affected the development of renewable energy projects, but it is safe to say that both the federal and state incentives have made renewable energy more cost competitive with traditional energy plants. This is particularly true with respect to wind and solar, which can take advantage of significant benefits from the PTC and ITC. For example, a wind project claiming the PTC and bonus depreciation might be able to raise about 50 to 60 percent of its capital costs from tax equity investors, while a solar project claiming the ITC and bonus depreciation might be able to raise about 35 to 45 percent of its capital costs. The percentages are a little less if bonus depreciation is not taken or available.

It is estimated almost 14 gigawatts (GW) of solar are expected to be installed in 2016, which is significantly more than the estimated 7.5 GW installed in 2015. Both the federal and state incentives have helped grow the renewable energy industry, which now supports about 700,000 jobs in the United States, and which has seen significant growth over the past decade.

MCC: What did last year's extension of the ITC and PTC do for renewable energy projects?

McCormick: In 2015, the PTC expired and only those wind projects that had begun construction before the end of 2014 were eligible to claim the PTC. In December of 2015, Congress adopted an extension of the PTC for wind, which runs through the end of 2019. The extension also has retroactive effect back to the 2014 expiration, however, the extension includes a 20 percent phase down in the PTC amount for projects beginning construction in 2017, with subsequent 20 percent phase downs for 2018 and 2018 projects.

The ITC was similarly extended for solar projects through the end of 2021 even though it was not set to step down to 10 percent until the end of 2016. The ITC extension also made other changes to bring it in line with the PTC, such as a friendlier "begin construction" requirement rather than the old "placed in service" requirement and adopting a phase down to 26 percent (rather than 30 percent) for solar projects that commenced construction in 2020 and 22 percent for solar projects that commenced construction in 2021. The personal tax credit for solar panels installed at a taxpayer's residence was similarly extended and with the same phase out; however, the personal tax credit for wind and geothermal heat pumps expires at the end of 2016.

The multiyear extension period for the PTC and the ITC will allow for more robust development

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of wind and solar projects and allow developers to strategically safe harbor projects that otherwise might not have been completed before the phase out or step down. The long PTC and ITC extensions put the renewable energy industry in an unprecedented period of certainty, particularly for wind projects. In the past, the wind industry had seen only one- or two-year PTC extensions, and those sometimes occurring after the PTC had already expired.

Unfortunately, the 2015 PTC and ITC extensions were not so generous to other technologies, such as geothermal, biomass, marine and tidal. These types of projects received an extension only to begin construction before the end of 2016 and, therefore, need to have already begun construction to qualify for the PTC or ITC.

MCC: What can developers of solar and wind projects do today to take advantage of the ITC and PTC extensions?

McCormick: Developers can safe harbor projects by beginning construction before the tax credits expire or step down. For example, wind project developers were very active starting construction of projects in 2016 to take advantage of the 100 percent PTC, rather than waiting until 2017 when only 80 percent of the PTC will be available. A developer can establish the commencement of construction by either starting "physical work of a significant nature" or spending at least 5 percent of the total project costs. The physical work test is most frequently used by developers, given that it relates to work, and not expenditures, thus being more cash-flow friendly. Work that would qualify for a wind project includes turbine foundation excavations, installing anchor bolts, pouring foundation pads, constructing turbine string roads or having a third-party vendor begin construction on a significant piece of equipment for the project, such as a step-up transformer. These rules then require the project to commence operation by the end of the fourth taxable year following the year construction commenced, or December 31, 2018, if that is later. The safe harbor rules issued by the IRS can be nuanced, so it is recommended to reach out to tax counsel if there are questions.

MCC: How might the upcoming change in administration impact the ITC and the PTC?

McCormick: There is speculation that President-elect Trump may eliminate the PTC and the ITC as part of his tax plan once he takes office. It is difficult to know for certain whether this will occur, and we should know more within the first few months after he takes office. Naturally, termination of the ITC and PTC would have a significant impact on new renewable energy projects in the U.S. These projects have relied heavily on tax credits to bring down their costs and to be competitively priced with other conventional generating resources. We have seen a dramatic cost reduction in solar panels over the past decade, but that alone hasn't been enough. I imagine states with RPS laws will still see development of renewables even if the ITC and PTC are terminated, but the cost of these projects will increase. The increased cost would most likely be reflected in the cost of power, which would ultimately be passed along to utility customers.

One probable outcome is one of compromise. This is because at least 60 of the 100 Senate votes will be needed to break a filibuster. This means that Republicans may need to work together and, to some extent compromise, with Senate Democrats to pass any long-term tax changes. Also, it may be possible that the ITC and the PTC will simply be left alone for the time being since they are already set to sunset between 2020 and 2023. The legislature may focus on technology-neutral tax incentives to supplant the ITC and PTC once these credits phase out.

MCC: If the ITC and the PTC remain unchanged, how might a change in corporate tax rates affect investment in solar and wind projects?

McCormick: A significant reduction in corporate tax rates would likely result in less tax equity being raised by developers, since the tax credits are less valuable to corporate taxpayers, resulting in developers either putting up more of their own equity or looking for loans to leverage their higher equity requirements.

Existing projects that have "flip structures" with tax equity investors might see the developers' retained equity interest increase in value. This would be particularly true with projects that claimed the ITC and bonus depreciation in tax years before a corporate tax rate change. This is primarily because the majority of the tax benefits in these flip structures are realized in early years, and once used, the depreciation and tax credits are no longer available to offset tax liability from operations, thus resulting in a net tax cost to tax equity in the later years. The decreased back-end tax costs might help these projects reach their flip point more quickly than first anticipated.