March 2018

An Act to provide for the reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018

SIDLEY

Overview

- Key provisions in (the legislation formerly known as) the Tax Cuts and Jobs Act
  - Reduced corporate tax rates
  - Repeal of the Corporate AMT
  - Immediate expensing
  - Interest expense limitations
  - Net operating losses (NOLs)
  - Contributions in aid of construction (CIAC)
  - Changes to taxation of multinational entities
- Impact on electric utilities
- Impact on renewables
  - Investment Tax Credit (ITC)
  - Energy Production Tax Credit (PTC)
  - Base erosion anti-abuse tax (“BEAT”)
- Technical corrections

Corporate Tax Rates

- Reduced to 21%
- Impact on Utilities
  - Consumers will benefit through rate reductions – timing?
    - Rates charged to customers allow utilities to recover operating expenses and earn a rate of return on their investment
    - Operating expenses include depreciation charges and tax liabilities
    - Straight line method used to determine depreciation charges for operating expenses
    - Tax liabilities currently calculated at the 35% rate
    - Formula rates where there is a periodic true up to actual costs? Determination by the governing regulatory body? Pending rate cases? Do you pass through the full amount of tax savings now or over time?
    - Credit ratings
      - Reduced cash flow to debt ratio
      - Moody's negative credit watch for certain utility companies

Corporate Tax Rates cont.

- Deferred tax balances
  - Timing difference between when utilities collect revenue from ratepayers for their federal income taxes and when they're paid to the IRS
  - Straight-line method vs. accelerated depreciation
    - Large early deductions for federal income tax purposes
    - Reduced taxes payable during early years
    - Increased taxes payable during later years

Corporate Tax Rates cont.

– Deferred tax balances example

- $100 million property placed in service in 2016
- Book depreciation: 10 year, straight line
- Tax depreciation: 5 years, 200% declining balance, half-year convention
- Tax rate 35%

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
Tax Depreciation	20.00	32.00	19.20	11.52	11.52	5.76	-	-	-	-	100.00
Book Depreciation	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	100.00
Difference	10.00	22.00	9.20	1.52	1.52	(4.24)	(10.00)	(10.00)	(10.00)	(10.00)	
Deferred Tax	**3.50**	**7.70**	**3.22**	**0.53**	**0.53**	**(1.48)**	**(3.50)**	**(3.50)**	**(3.50)**	**(3.50)**	-

Corporate Tax Rates cont.

– What drives large deferred tax balances?
  - increase in capital spending on infrastructure over the past 15 years
  - the bonus depreciation incentives put into place in 2008

– Excess deferred tax balances were created as a result of the reduction in tax rates
  - The difference between the utility’s deferred taxes at the 35% rate versus the 21% rate
  - In effect cancels future expected income tax payments
  - Taxes already collected and accounted for in a deferred tax account

Corporate Tax Rates cont.

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
Tax Depreciation	20.00	32.00	19.20	11.52	11.52	5.76	-	-	-	-	100.00
Book Depreciation	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	100.00
Difference	10.00	22.00	9.20	1.52	1.52	(4.24)	(10.00)	(10.00)	(10.00)	(10.00)	
35% Tax Rate											
Deferred Tax	3.50	7.70	3.22	0.53	0.53	(1.48)	(3.50)	(3.50)	(3.50)	(3.50)	
21% Tax Rate											
Deferred Tax	2.10	4.62									
Excess Deferred Tax	**1.40**	**3.08**									**4.48**

Corporate Tax Rates cont.

- Excess Deferred Tax Balances
  - As of December 31, 2017, for taxpayers subject to normalization method of accounting (e.g. regulated public utilities), excess deferred taxes are refunded to customers over the book life of property
  - Normalization
    - Avoids sharp fluctuations in rates charged to customers
    - Accelerated depreciation is intended to stimulate capital investment
  - From and after January 1, 2018, utilities will record current and deferred taxes at the new 21% rate and, consistent with the normalization rules, the additions to the deferred tax reserve will also reflect that rate. To the extent utility rates charged to customers continue to reflect the prior 35% federal income tax rate, any “excess” revenues collected are potentially subject to immediate refund as they are not protected by normalization.

Alternative Minimum Tax - Repealed

- Prior law:
  - Higher of regular corporate income tax and AMT
  - AMTI*20%
  - the 90% limitation in the AMT resulting in a 2% tax rate (20% AMT rate multiplied by the 10% of income that cannot be offset with an NOL deduction)
- Caveat: Deduction for NOLs arising after December 31, 2017 is limited to 80% of taxable income resulting in a 4.2% tax rate (21% corporate tax multiplied by the 20% of income that cannot be offset with NOLs).
- A corporation with AMT credit carryforwards may claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2018, 2019 and 2020, and allows a refund of all remaining credits in the tax year beginning in 2021

Immediate Expensing

- Bonus depreciation increases from 50% to 100% for “qualified property” placed in service after September 27, 2017, and before 2023
- Allows for immediate deduction of 100% of costs of qualified property as opposed to recovering costs over time under MACRS
- Phase down
  – 2023: 80%
  – 2024: 60%
  – 2025: 40%
  – 2026: 20%
- Original use of the property does not need to commence with the taxpayer

Immediate Expensing cont.

- Qualified property EXCLUDES
  - property used in the trade or business of furnishing or selling electrical energy, water, or sewage disposal services, gas or steam through a local distribution systems, or the transportation of gas or steam by pipeline
  - **IF** the rates for furnishing or selling have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof or by the governing or ratemaking body of an electric cooperative.

Interest Limitations – 163(j)

- Deduction for “business interest” is limited to the sum of (i) business interest income, plus (ii) 30% of adjusted taxable income (ATI)
- “Business interest”: interest paid or accrued on indebtedness properly allocable to a trade or business. Trade or business does not include:
  - performing services as an employee
  - a real property trade or business
  - certain activities of regulated utilities
- For taxable years beginning before January 1, 2022, ATI is taxable income computed without regard to depreciation, amortization, or depletion
- For taxable years beginning on or after January 1, 2022, ATI is decreased by depreciation, amortization, or depletion
- Disallowed interest is carried forward indefinitely

Interest Limitations – cont.

- Trade or business EXCLUDES:
  - the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution systems, or the transportation of gas or steam by pipeline
  - **IF** the rates for furnishing or selling, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.
- Allocation among regulated utility assets and other assets?

Net Operating Losses

- Prior law: NOLs were carried back 2 years, forward 20 years, and were not subject to a yearly limitation (other than the Corporate AMT). Specified liability losses carried back 10 years under Section 172(f).
- For NOLs arising in taxable years beginning after 2017
  - the NOL deduction is limited to 80% of taxable income
  - Can no longer carryback NOLs
  - Can carryforward NOLs indefinitely
- Corporations must track NOLs arising in tax years beginning (1) on or before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be subject to the 80% limitation.
- As a capital intensive industry, power and utility companies often have NOLs due to bonus depreciation, as well as other expenses such as environmental, workmen's compensation and tort claims, Section 172(f) allowed them to carry these other expenses to profitable years and obtain a refund of taxes previously paid.

Contributions in Aid of Construction (CIAC)

- Prior law:
  - contributions to the capital of a corporation not taxable to the corporation (Section 118(a))
  - CIAC or other contribution by a customer or potential customer is a taxable contribution (Section 118(b))
  - CIAC to water utilities not taxable to the corporation (Section 118(c))
- Excludes from Section 118(a) any CIAC or other contribution by a customer or potential customer, *government entity or civic group*
- Repeals Section 118(c) exclusion from gross income for water utilities
- Purpose: to eliminate federal tax subsidy for state and local incentives and concessions granted to corporations to incentivize them to locate operations within the grantor's jurisdiction

Base Erosion Anti-Abuse Tax (“BEAT”)

- The new Section 59A “base erosion and anti-abuse tax” (BEAT) is a minimum tax imposed on certain large corporate taxpayers
  - Generally, BEAT applies to domestic corporate taxpayers and foreign taxpayers that have income effectively connected with the conduct of a U.S. trade or business and that make certain payments to related foreign parties
- Taxpayers excluded from BEAT:
  - BEAT does not apply to taxpayers that are S corporations, real estate investment trusts, or regulated investment companies
  - BEAT does not apply to taxpayers with average annual gross receipts of less than $500 million in the prior three taxable years
  - BEAT does not apply to taxpayers with *de minimis* payments to related foreign parties
- The BEAT is calculated as a percentage of the taxpayer’s *modified taxable income* less the taxpayer’s actual tax liability
  - The BEAT tax rate is equal to 5% of modified taxable income for 2018
  - The rate is equal to 10% for 2019-2024
  - The rate is 12.5% beginning in 2025 (increase in order to meet revenue targets)
  - Each of the rates above is increased by 1% if the taxpayer is a bank or securities dealer

Calculation of Modified Taxable Income

- ***BEAT = (10% * Modified taxable income) – (Actual Tax Liability) [2019]***
- Modified taxable income is determined by adding back to taxable income certain current year deductions involving payments to related foreign persons
  - For this purpose, a foreign person is generally considered related if they own (directly or indirectly) 25% or more of the stock of the taxpayer by vote or value
- Amounts added back to taxable income generally consist of deductible payments to foreign related persons, including:
  - Interest
  - Rent
  - Royalties
  - Service fees
  - Depreciation on assets acquired from foreign related parties (only applies to property purchased after December 31, 2017)

Calculation of Modified Taxable Income

- However, a payment is not added back to taxable income if such payment was subject to full U.S. tax withholding when made
- Similarly, if a payment is subject to a reduced withholding tax rate due to an applicable tax treaty, such payment only added back proportionately
- No amount is added back for the 100% dividends received deduction from a foreign corporation for which the 100% deduction is allowable
- If the interest expense of the taxpayer is limited by new Section 163(j), BEAT considers the non-deductible amount to be first allocated to loans with unrelated persons
  - This is favorable to the Treasury as the amount of BEAT due will not decrease from reductions of interest allocated to unrelated persons
- *De Minimis Rule*
  - If the amount of items added back to the calculation of modified taxable income is less than 3% of total deductions of the taxpayer (with certain adjustments), then BEAT does not apply for that year.
  - The *De Minimis* amount is 2% for certain banks and securities dealers

Calculation of Actual Tax Liability

- ***BEAT = (10% * Modified taxable income) – (Actual Tax Liability) [2019]***
- In addition to the items added back when determining modified taxable income, certain reductions are made to the taxpayer's actual tax liability when determining BEAT
- These reductions consist generally of all tax credits allowable to the taxpayer, including foreign tax credits.
  - Prior to 2026, certain tax credits are exempted from this requirement:
    - 100% of the research credit under Section 38 is exempted
    - 80% of the low income housing credit, renewable energy production credit, and investment credit, but only to the extent allocable to the energy credit under Section 48
  - Thereafter, all credits reduce the taxpayer's actual tax liability when determining BEAT
- By reducing the actual tax liability of the taxpayer for all tax credits when determining the BEAT, the amount of BEAT due will be increased
  - This effectively reduces the value of tax credits by imposing a minimum tax of 10% on the taxpayer

Calculation of the BEAT

- ***BEAT = (10% * Modified taxable income) – (Actual Tax Liability) [2019]***
- The calculation of BEAT is made on a group basis
  - All members of the taxpayer's affiliated group are combined and all group member's related party payments, taxable income, credits, etc. are aggregated
- If the BEAT is a positive number then the amount is imposed as an additional tax on the taxpayer.
- *Example –*
  - Taxpayer is a domestic corporation with tax credits. In 2019, the taxpayer earns $2 billion in taxable income and would pay $420 million in tax before taking into account tax credits. Assume tax credits reduce the taxpayer's tax liability to $380 million. The taxpayer's modified taxable income is $4 billion which, applying a 10% rate, would equal $400 million. The BEAT tax would be $20 million calculated as 10% of the taxpayer's modified taxable income ($400) less the taxpayer's actual tax liability reduced for tax credits ($380).
- Therefore, in this example the BEAT has the effect of denying the taxpayer the benefit of half of its tax credits

Technical Corrections

- Typically “technical” in nature, and does not make major policy changes
- Due to the speed at which the tax act was passed, technical corrections will be needed
- Not subject to budget reconciliation process – 60 votes needed in the Senate

Questions?

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