Bloomberg BNA

Daily Tax Report®

Energy

Lower Corporate Tax Rate May Alter New Energy Project Investment

A 20 percent corporate tax rate proposed in the new Republican tax framework Sept. 27 could reduce tax equity investments in future renewable energy projects, meaning that developers may need to find new funding mechanisms.

Tax equity investors—typically banks or insurance companies—''would give less than they would under the 35 percent tax rate,'' Vadim Ovchinnikov, a director at Alfa Energy Advisors LLC, told Bloomberg BNA. Alfa assists project developers, investors, lenders, and government institutions in developing and financing energy projects.

Tax equity investors have a passive ownership interest in a project and receive a return based on federal and state income tax benefits and cash flow from the deal. An investor discounts its projected net benefits stream—tax credits, depreciation, and other benefits minus the taxes it expects to pay on its share of allocated income—at its target yield to determine what to invest, said Keith Martin, co-head of U.S. projects at Norton Rose Fulbright.

''The lower the corporate tax rate, the smaller the tax savings from losses (depreciation), but the less in taxes the investor will have to pay on the income it is allocated,'' Martin said. ''Because losses come first and then income comes later, the time value of the reduction in tax savings usually exceeds the benefit from having to pay less in taxes later.''

Tax equity investments can comprise up to about 70 percent of the total capital structure for wind projects and 50 percent for solar projects, according to a joint presentation by Alfa Energy Advisors and Mayer Brown LLP in June. The impact of tax reform on renewable energy projects was also a topic of conversation at the American Bar Association tax section meeting in Austin, Texas, in early September.

Running the Numbers Tax equity investment in new wind projects would fall in 2018 from an average of 68 percent of total capital to between 62 percent and 57 percent if the corporate rate is between 25 percent and 15 percent, respectively, according to an analysis by Alfa. For new yield-based solar projects in 2018, tax equity investment would decline from about 40 percent to between 38 percent and 36 percent. These figures assume that current tax benefits, such as the production tax credit for wind and the investment tax credit for solar projects, are unchanged in tax reform.

If the rate is lowered and tax equity investments decline, developers will have to make up the gap in the capital stack through more debt or with equity, Martin said in an April article.

''Lower rates in general could certainly impact the overall value of a tax-equity project, which could impact the ability to raise capital,'' but the corporate rate is only part of the equation, said Greg Matlock, Ernst and Young LLP's Americas Energy Tax Leader. Cost recovery provisions such as immediate expensing—which the tax framework proposed for at least five years for new investments in depreciable assets other than structures—are also important, he said. Those types of provisions can affect a renewable energy project's overall internal rate of return, which is a driving force in tax equity deals, he said.

Core Financing Tool In the U.S. renewable energy market, ''partnership flips'' are the most common structures for raising tax equity—approximately 80 percent of the solar market and 100 percent of the wind market, Martin said.

In a partnership flip, the project developer and the tax equity investor become partners in a limited liability company. The developer acts as the managing member, making day-to-day decisions, while the investor plays a relatively passive role. The investor takes advantage of tax benefits generated by the project—which few developers can use efficiently because of various tax regulations—in return for providing capital.

Generally, the investor is initially allocated as much as 99 percent of the tax benefits—credits and depreciation—and subsequently ''flips'' down to as little as 5 percent after achieving a specified after-tax internal rate of return.

Tax rate changes would affect existing renewable energy partnership flip deals differently than new ones, Martin said. The effect on current projects depends on where the deal is in its life cycle when the rate is cut, he said. ''If the rate is reduced early in the deal, then it's more likely to push out the flip date. If it's later, it's more likely to accelerate it,'' Martin said.

''The reason is that these deals tend to show tax losses for the first three years and then they turn tax positive,'' he said. If the rate is slashed when the partnership is tax positive ''that just means less in tax will be paid by the owners and therefore, the tax equity investor reaches'' its target internal rate of return sooner.

Will Investors Lose Interest? David K. Burton, a partner in Mayer Brown LLP's New York office and a member of the firm's tax transactions & consulting practice, said a lower corporate rate also raises the question of whether fewer companies will invest in new renewable energy projects through tax equity deals because they will have less need for the tax benefits.

While lower tax rates may deter some participants ''on the margins,'' even at a 20 percent rate the largest tax equity investors, ''such as JP Morgan and US Bank, will have tax liability that they would rather satisfy by making a tax equity investment that earns a return than to just cut a check to the United States Treasury,'' Burton said.

Tax rates and overall after-tax positions are important, Matlock said, but certain investors will continue to be interested in renewable projects because of sector focus, geographic preferences, or diversity of investment preferences.

Renewable investments should continue to attract investors because of overall global and domestic energy needs, he said.

By Allyson Versprille

To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bna.com

To contact the editor responsible for this story: Meg Shreve at mshreve@bna.com

DTR ISSN 0092-6884