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Key Energy-Related Tax Provisions in the 2014 Budget Proposal

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President Obama's recently released budget proposal for the 2014 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 strong support for renewable energy.

The Obama administration's budget proposal (Proposal) affects several energy-related tax provisions, some of which were also proposed in the 2013 revenue proposal. Click here for more information on the energy tax provisions in the 2013 proposed budget.

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

Modify and Permanently Extend the Renewable Production Tax Credit

The PTC for certain qualifying energy facilities pursuant to section 45 of the Internal Revenue Code of 1986, as amended (Code), is set to expire on December 31, 2013, if construction of the qualified facility is not begun by such date.

The PTC is a credit (indexed annually for inflation) per kilowatt-hour of electricity produced from qualified energy facilities. Qualified energy resources include wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. The base amount of the PTC is 1.5 cents (indexed annually for inflation) per kilowatt-hour of electricity produced. For 2013, the amount of the credit is 2.3 cents per kilowatt-hour for wind, closed-loop biomass, geothermal energy and solar energy, and 1.1 cent per kilowatt-hour for open-loop biomass, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy.

According to the Green Book, the Proposal would permanently extend the PTC and make it 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. In addition, the PTC would be extended to electricity produced from solar facilities. The refundable tax credit would be available for property on which construction begins after December 31, 2013.

Enhance and Make Permanent the Research and Experimentation Tax Credit

The research and experimentation (R&E) credit pursuant to section 41 of the Code is set to expire on December 31, 2013. The R&E 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 would increase the rate of the ASC from 14 percent to 17 percent, effective after December 31, 2012.

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, micro turbines 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, as a result of the unavailability of the credit.

The Proposal would authorize an additional $2.5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. 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. This change would be effective as of the date of enactment.

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. Currently, the NMTC can be used to offset regular federal income tax liability but cannot be used to offset alternative minimum tax (AMT) liability. The NMTC is set to expire on December 31, 2013.

The Proposal would permanently authorize the NMTC allocations with an allocation amount of $5 billion for each round. The Proposal also would permit NMTC amounts resulting from qualified investments made after December 31, 2012, to offset a taxpayer's AMT liability. This proposal would be effective upon enactment.

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, 2014 through 2016.

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. However, after 2013, 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 2013—*i.e.*, a maximum deduction of $500,000, with an investment threshold limit of $2 million. These thresholds would be indexed for inflation for all taxable years beginning after 2013. 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, 2013.

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 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, 2013.

Elimination of Fossil Fuel Preferences

The Proposal's expenditures are to be funded in part by the elimination of fossil fuel preferences. The Proposal would eliminate most fossil fuel tax preferences. Specifically, the Proposal would take the following actions, among others:

- Repeal the enhanced oil recovery credit for taxable years beginning after December 31, 2013.

- Repeal the credit for oil and gas produced from marginal wells for production in taxable years beginning after December 31, 2013.
- Repeal expensing for intangible drilling costs and 60-month amortization of capitalized intangible drilling costs for costs paid or incurred after December 31, 2013.
- Repeal the deduction for qualified tertiary injectant expenses for amounts paid or incurred after December 31, 2013.
- Repeal the exception to the passive loss limitation for working interests in oil and natural gas properties for taxable years beginning after December 31, 2013.
- Repeal percentage depletion for oil and natural gas wells for taxable years beginning after December 31, 2013. 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.
- Increase the geological and geophysical amortization period from two years to seven years for independent oil and gas producers for amounts paid or incurred after December 31, 2013.
- Repeal expensing, 60-month and 10-year amortization for exploration and development costs relating to coal and other hard-mineral fossil fuels for costs paid or incurred after December 31, 2013. 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 capital gains treatment of coal and lignite royalties in favor of taxing those royalties as ordinary income, effective for amounts realized in taxable years beginning after December 31, 2013.
- Exclude from the domestic manufacturing deduction gross receipts derived from the sale, exchange or other disposition of oil and natural gas for taxable years beginning after December 31, 2013. A similar proposal would apply to coal and hard mineral fossil fuel production.

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