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Power and utilities provisions, Ways and Means tax reform bill

The U.S. House Ways and Means Committee on November 9, 2017, reported a tax reform bill—H.R. 1, the "Tax Cuts and Jobs Act"—to the full House.

The Ways and Means tax reform bill (as well as a section-by-section summary description) was originally released by Ways and Means Chairman Kevin Brady (R-TX) on November 2. Amended legislative text of H.R. 1 was released on November 3, known as the "Chairman's mark" (that served as the starting point for consideration of the legislation by the Ways and Means Committee). The Chairman's mark was reported (approved) by the House Ways and Means Committee on November 9, and the legislation is scheduled to be considered by the full House on November 16. Read KPMG's **report** [PDF 1.7 MB] providing initial analysis and observations on the Ways and Means bill.

The Senate Finance Committee Chairman released his Chairman's mark (the "Senate Finance Chairman's mark") on November 9. The markup of that legislation began on November 13, and is expected to be continued through the week. The Senate Finance Committee is expected to report its legislation by the end of this week. Statutory language for the Senate legislation is not yet available. Read KPMG's **report** [PDF 1.1 MB] providing initial analysis and observations on the Senate Finance Chairman's mark for tax reform.

Power and utility provisions in tax reform bill

The following discussion provides initial impressions of certain proposals in the Ways and Means tax reform bill that are considered to be of greatest importance for the power and utility industry, and compares those provisions to similar proposals in the Senate Finance Chairman's mark.

Corporate tax rate reduction

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Reduction of maximum corporate income tax rate to 20%. A provision of the Ways and Means bill (section 3001) would eliminate the progressive corporate income tax rate structure, currently imposing a maximum U.S. corporate income tax rate of 35%, and would replace it with a flat tax rate of 20% (and make various corresponding changes throughout the Code). Further, the U.S. corporate income tax rate on personal service corporations would be reduced to 25%, resulting in a 10 percentage point reduction from the current rate of 35%. The new rates would be effective for tax years beginning after 2017. The Ways and Means bill would also repeal the alternative corporate tax on net capital gain (Code section 1201). The JCT estimated that this provision will decrease revenues by $1.462 trillion over 10 years.

The Senate Finance Chairman's mark would also reduce the maximum corporate income tax rate to 20%, but the change would be effective for tax years beginning after 2018. The Senate mark would eliminate the special tax rate for personal services corporations.

KPMG observation

This reduction is intended to make the U.S. corporate income tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the bill, this provision would reduce tax rates in exchange for the elimination of certain tax benefits.

The bill's proposed flat 20% corporate tax rate is higher than the 15% rate proposed by President Trump's tax plan, but corresponds with the 20% rate proposed in the House Blueprint released in June 2016.

Excess deferred taxes for public utility property

As part of the corporate tax reduction, section 3001 of the Ways and Means bill provides that a normalization method of accounting would be used for excess tax reserves associated with public utility property. Consistent with the Tax Reform Act of 1986, the measure would provide for the use of the average rate assumption method (ARAM) for the determination of the timing of the return of the excess deferred taxes. However, the Ways and Means bill also allows for an alternative method if the books and underlying records do not contain the vintage account data necessary to apply ARAM. A new provision would be added to address a violation of the normalization requirement. A violation would result in an increase in tax by the amount by which the taxpayer reduces its excess deferred tax reserve more rapidly than permitted under the normalized method of accounting.

The Senate mark appears to include a similar provision.

Limitation on the deduction of net business interest expense

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Section 3301 of the Ways and Means bill would amend section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income.

For this purpose, adjusted taxable income generally would be a business's taxable income (and could not be less than zero) computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) depreciation, amortization, and depletion. Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business.

Disallowed interest expense could be carried forward only five years.

For this purpose, a trade or business subject to the new rules would not include the trade or business of furnishing or selling electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale are subject to rate regulation.

The provision would be effective for tax years beginning after 2017. The JCT estimates the provision would increase revenues by approximately $172 billion over 10 years.

The Senate Finance Chairman's mark appears to include a similar provision, but unlike the provision in the Ways and Means bill, it would not exclude depreciation, amortization, and depletion from adjusted taxable income. In addition, the Senate mark would provide an indefinite carryforward for disallowed interest expense.

KPMG observation

It is unclear how it will be determined what is "properly allocable to a trade or business." Business interest not properly allocable to the delineated regulated businesses would be either properly allocable to some other trade or business or would presumably be treated as other types of interest and subject to existing rules for the treatment of interest (e.g., investment interest).

Cost recovery - Increase expensing

Under section 3101 of the Ways and Means bill, the additional first-year depreciation deduction (bonus depreciation) would be increased and expanded.

According to the Ways and Means bill, generally, the bonus depreciation percentage would be increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023 (with an additional year for certain qualified property with a longer production period).

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The proposed statutory language would expand the definition of qualified property to include used property, provided it is the taxpayer's first use of the property. Under current law, bonus depreciation is available only for property, the original use of which begins with the taxpayer.

The definition of qualified property would be modified to exclude any property used in a trade or business of furnishing or selling electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale are subject to rate regulation.

Under the proposed statutory language, a provision that allowed corporate taxpayers to treat AMT credits as refundable in lieu of claiming bonus depreciation, would be repealed, effective for tax years after 2017.

In the case of the taxpayer's first tax year ending after September 27, 2017, the taxpayer could elect to apply section 168 without regard to the amendments made by the proposed statutory language. The proposed statutory language further provides that in the case of any tax year which includes any portion of the period beginning September 28, 2017, and ending on December 31, 2017, the amount of any net operating loss that may be treated as a carryback would be determined without regard to the amendments made by the proposed statutory language.

Special anti-abuse transition rules would apply to qualified property acquired by the taxpayer before September 28, 2017, and placed in service after September 27, 2017. The JCT estimates that the provision (with the December 31, 2022 sunset date) would decrease revenues by $25 billion over 10 years.

The Senate Finance Chairman's mark contains similar provisions except that bonus depreciation would not be available for used property.

KPMG observation

If the Ways and Means provision is ultimately enacted, it could have an important effect on M&A transactions. It would increase the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to section 338) asset purchases—rather than stock acquisitions—by enabling the purchasing entity in an asset acquisition to immediately deduct a significant component of the purchase price, and potentially to generate net operating losses in the year of acquisition that could be carried forward (with annual increases for an interest component) to shield future income.

Revisions of treatment of capital contributions

Repeal contribution-to-capital rules. Section 3304 of the Ways and Means bill would repeal Code section 118 (which currently provides that a corporation does not recognize income on its receipt of a capital contribution) and add a new section—section 76. New Code section 76 would provide that gross income includes any

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contribution to the capital of a corporation, other than a contribution of money or property made in exchange for stock of such corporation; however, the exception for contributions in exchange for stock would apply only to the extent that the fair market value of the money or other property does not exceed the fair market value of the stock received in the exchange at the time of contribution. Similar rules would apply to entities other than corporations.

The Ways and Means bill would make a conforming change under Code section 362(a) with respect to the rules for determining the basis of certain property acquired by corporations in certain tax-free transactions, providing that the corporation would take a carryover basis in property contributed only when stock of the corporation is issued in the exchange.

The bill also would amend Code section 362(c) to provide that, if property other than money is transferred to a corporation as a contribution to capital within the meaning of section 76, the basis of such property in the hands of the corporation would be the greater of: (1) the basis of the property in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer; or (2) the amount included in gross income by the corporation under section 76.

The bill also would repeal section 108(e)(6). Currently, section 108(e)(6) provides that, for purposes of determining cancellation of indebtedness income, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, section 118 does not apply, but the corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's basis in the debt. The bill would be effective for contributions made and transactions entered into after the date of the enactment.

The JCT has estimated that the provision would increase revenues by approximately $7.4 billion over 10 years.

The Senate Finance Chairman's mark does not include a similar provision.

KPMG observation

The House Ways and Means provision would replace section 118 and therefore would appear to eliminate non-taxable contributions in aid of construction (CIAC) for water companies and other non-taxable CIACs under exiting guidance.

Repeal deduction for income attributable to domestic production activities

Under section 3306 of the Ways and Means bill, the deduction for domestic production activities provided under section 199 would be repealed for tax years beginning after December 31, 2017.

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A separate provision of the bill would extend the section 199 deduction for income attributable to qualifying activities performed in Puerto Rico for tax years before January 1, 2018 (a one-year extension).

The JCT has estimated that repealing section 199 would increase revenues by approximately $95.2 billion from 2018-2027. The one-year extension related to Puerto Rico would decrease revenues by approximately $800 million over the same 10-year period.

The Senate Finance Chairman's mark includes a similar provision, but it would not include relief for Puerto Rico and it would be effective for tax years beginning after December 31, 2018.

KPMG observation

The original intent of the section 199 deduction was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this proposed provision would eliminate the rate reduction created by section 199, a separate provision of the Ways and Means bill proposes an overall corporate rate reduction (discussed above). While accelerating income to or deferring deductions from the final year in which section 199 is available may provide a permanent increase in the amount of the domestic production activities deduction that is available, such potential planning must be balanced against the benefits of more traditional planning (deferral of income and acceleration of deductions) in the context of tax rate reform.

Repeal of corporate AMT

Section 2001 of the Ways and Means bill would repeal the corporate alternative minimum tax (AMT) effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally could be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2019, 2020, and 2021, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers would be refundable (a proration rule would apply with respect to short tax years). Any remaining AMT credits would be refundable in 2022.

While the Ways and Means bill would repeal the AMT, it would also limit the NOL deduction for a given year to 90% of taxable income, adding a limitation that currently exists only in the AMT area.

The JCT has estimated that the repeal of the corporate AMT would reduce revenues by approximately $40.3 billion over a 10-year period.

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The Senate Finance Chairman's mark includes a similar provision except that the credits would be 50% refundable in 2018, 2019, and 2020, and 100% refundable in 2021.

KPMG observation

In general: Repealing the corporate AMT would eliminate some of the complexity inherent in U.S. corporate taxation. For taxpayers with significant corporate AMT credit carryovers, the Ways and Means bill's generous rules would allow the full use of the credits to reduce or eliminate regular tax liability, and to obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

Natural resources: The repeal of the corporate AMT also would eliminate the ability of taxpayers to use the optional 10-year write-off contained in Code section 59(e) to minimize the disparity between certain AMT adjustments and preference items, which makes a taxpayer's regular income tax closer to the alternative minimum tax. This change would affect intangible drilling and development costs for oil, gas, and geothermal wells (integrated oil corporations would still be required to capitalize 30% of their IDC allowable as a deduction ratably over the 60-month period beginning with the month in which the costs are paid or incurred) and the deduction for certain mine exploration and development expenditures. Under the AMT regime, mines were generally limited to cost depletion. However, for regular income tax purposes, depletion on mines would remain the higher of cost or percentage depletion for the tax year. Independent oil and gas producers could still claim the higher of cost depletion or percentage depletion under section 613A.

The Senate mark does not include a similar provision.

Modify the credit for electricity produced from certain renewable resources

Section 3501 of the Ways and Means bill would make two modifications to the credit for electricity produced from certain renewable resources.

First, it would reduce the production tax credit rate for facilities that begin construction after the date of the enactment of the legislation. The rate would be reduced from its current rate of 2.4 cents per kilowatt hour (as adjusted annually for inflation) for wind energy to 1.5 cents, and the rate would no longer be adjusted for inflation.

Second, the proposed statutory language would add a new statutory requirement that a taxpayer must demonstrate that the construction of any facility may not be treated as beginning before any date unless there is a continuous program of construction that begins before such date and ends on the date that such property is placed in service. This provision would apply to tax years beginning before, on or after date of enactment.

The JCT estimated that the provision would increase revenue by $12.3 billion over 10 years.

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The Senate Finance Chairman's mark does not include similar provisions.

KPMG observation

This new statutory requirement would apply retroactively to facilities that have already begun construction. However, existing IRS guidance includes a similar continuous construction requirement, so it is not immediately clear what effect this new statutory requirement is intended to have.

Modify credit for production from advanced nuclear power facilities

Section 3506 of the Ways and Means bill would amend the credit allocation process for the credit for production from advanced nuclear power facilities and would allow a transfer of the credit by certain public entities. Beginning after 2021, any allocated national megawatt capacity that remains unused would be re-allocated in the following order—first, to such facilities that did not receive an allocation equal to their full capacity; and second, to facilities placed in service thereafter in the order in which such facilities are placed in service. The proposed statutory language also would allow certain public entities to elect to transfer the credit to specified project participants (e.g., participants in design and construction, providers of nuclear steam supply systems or nuclear fuel, partners, and co-owners).

The clarification to the credit allocation process would be effective on the date of enactment, and the election for credit transfers would be effective for tax years beginning after the date of enactment.

The JCT estimated that the provision would reduce revenue by $400 million over 10 years.

The Senate Finance Chairman's mark does not include a similar provision.

KPMG observation

As originally enacted, in order to claim the credit, the facility must have been allocated a national megawatt capacity limitation by the IRS and placed in service before 2021. As this allocation occurred before the facility was actually placed in service, some facilities—once placed in service—may not reach the allocated amount of the national megawatt capacity, or construction may not be completed by the deadline. The proposed statutory language determines that all allocated national megawatt capacity is fully utilized through a re-allocation process.

Additionally, the proposed statutory language brings relief to public entities that are owners (or co-owners) of certain nuclear power facilities to which the IRS allocated the national megawatt capacity limitation for purposes of claiming the credit. The public entities are not subject to federal income tax; therefore, such owners would have been unable to claim the benefit of the credit.

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