Tax Provisions in Biden Administration's FY 2022 Budget Proposals

Energy and natural resources

June 18, 2021

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Introduction

KPMG LLP on May 31, 2021, released a 117-page **report** [PDF 1.4 MB] containing analysis and observations of tax proposals in the Biden Administration's FY 2022 budget. For ease of reference, KPMG has compiled summaries and observations relating to certain industries and topics in separate booklets. This booklet highlights revenue proposals relating to energy and natural resources. Other booklets will address proposals relating to other topics.

This booklet reflects developments and analysis as of June 16, 2021. For information regarding subsequent developments, read ***TaxNewsFlash-Legislative Updates***.

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This booklet is organized as follows:

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Background

The Department of the Treasury ("Treasury") on May 28, 2021 released its "**General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals**" [PDF 884 KB]. This document, better known as the "Green Book," outlines the Biden Administration's tax proposals in greater detail than seen before, including information on proposed effective dates, Treasury revenue estimates, and design choices.

During the presidential race of 2020, Biden actively campaigned on an ambitious tax plan. His campaign tax plan was in some ways centered on the idea that the major tax legislation enacted in 2017 typically called the Tax Cuts and Jobs Act ("TCJA"), championed by the Trump Administration, had cut taxes too much and in the wrong ways. Read **KPMG's detailed analysis of the TCJA** [PDF 6.4 MB].

As such, candidate Biden's tax plan was built around raising the corporate tax rate, raising taxes on the foreign earnings of U.S. multinationals, and raising taxes on wealthy individuals (including increases in the ordinary and capital gains tax rates). The plan would then redirect that tax revenue to other priorities, such as infrastructure spending and support for middle and low-income earners.

Since becoming president, Biden has continued to champion mostly the same ideas from his campaign. He has, however, focused his legislative efforts so far on a narrower set of tax proposals than in his campaign, while introducing several new proposals.

The FY 2022 Green Book reflects the Biden Administration's current tax priorities—signaling to Congress the administration's view that these ideas are of greatest importance to President Biden's current legislative agenda. With Congress gearing up to consider major tax and infrastructure legislation later this year, the Green Book ideas are likely to be central to those discussions. Biden Administration officials were, no doubt, keenly aware of this fact when developing these proposals.

While the Green Book includes a great deal of information, it nevertheless leaves many questions unanswered. Those answers may be delayed pending actual legislative text from Congress, or, if legislation based on the proposals is enacted, post-enactment regulatory guidance from Treasury. But, for now, the Green Book reflects the most detailed exposition of the administration's current legislative priorities for the U.S. tax system.

Highlights of tax proposals

The tax proposals in the Biden Administration's budget for FY 2022 are generally consistent with the corporate, international, individual, and investment tax proposals in the previously announced Made in America Tax Plan, the American Jobs Plan, and the American Families Plan. There are, however, some important new details and modifications, as well as a few new proposals and one significant recommendation with regard to an effective date.

Read [***TaxNewsFlash***] and [***TaxNewsFlash***]

Corporate and international revenue-raising proposals include:

- Increasing the statutory corporate rate to 28%
- Imposing a 15% minimum tax on global book income of certain large corporations
- Reducing to 25% the deduction for "global intangible low-taxed income" (GILTI), eliminating the "qualified business asset investment" (QBAI) exemption, and imposing a jurisdiction-by-jurisdiction calculation
- Repealing the deduction for "foreign-derived intangible income" (FDII)
- Replacing the "base erosion anti-abuse tax" (BEAT) with a new "stopping harmful inversions and ending low-tax developments" (SHIELD) regime that would deny U.S. tax deductions for payments to foreign related parties subject to a "low effective tax rate"
- Limiting the ability of domestic corporations to expatriate by tightening the anti-inversion rules
- Restricting the deduction of interest by a financial reporting group attributable to disproportionate U.S. borrowing
- Expanding the application of section 265 to disallow deductions attributable to income exempt from tax or taxed at a preferred rate
- Denying certain deductions related to offshoring jobs
- Increasing the IRS enforcement budget
- Limiting foreign tax credits from sales of hybrid entities
- Reinstating Superfund taxes

Individual and investment tax proposals include:

- Increasing the top individual income tax rate to 39.6%
- Taxing long-term capital gains and qualified dividends at ordinary rates for taxpayers with adjusted gross income exceeding $1 million (applicable to gains required to be recognized after the date of announcement)
- Treating transfers of appreciated property upon death or by gift with unrealized capital gains appreciation in excess of $1 million as realization events, with exclusions for donations and certain tangible personal property and deferral of gain for family-owned and operated businesses—special rules providing for spousal portability and treatment of capital gains attributable to a primary residence also would apply
- Taxing carried (profits) interest income as ordinary income
- Limiting section 1031 like-kind exchanges
- Making permanent the current limitation on excess business losses of noncorporate taxpayers
- Modifying the net investment income and Self-Employment Contributions Act (SECA) tax rules for high-income taxpayers with certain income related to passthrough entities
- Providing additional funding for tax administration to improve compliance
- Requiring financial institutions to report information on account flows

Tax credit-related proposals

In addition to its revenue-raising proposals, the Biden Administration also included as part of its long-term plans a number of tax credits and preferences for social programs and income support, including:

- Extending the expansion of the Child Tax Credit to certain children through 2025 and making the credit fully refundable

- Making permanent the expansions to the Child and Dependent Care Tax Credit
- Making permanent the expansions to the Earned Income Tax Credit for childless workers
- Extending the expanded Affordable Care Act (ACA) premium tax credits

Effective dates

Congress will ultimately determine the effective dates of any tax legislation, as well as any transition and grandfather rules it deems appropriate. In most cases, the Green Book proposes that the tax changes be effective January 1, 2022 (which is how budget recommendations are ordinarily submitted). There are exceptions, however, including:

- The proposal to tax long-term capital gains and qualified dividends for high-income taxpayers at ordinary rates would be effective, according to the Green Book, "for gains required to be recognized after the date of announcement." It is unclear whether the applicable date would be the date of the transmittal of the budget (that is, May 28, 2021) or the earlier date of release of the American Families Plan in April 2021. Either way, the proposal would be effective for future realizations, if Congress were to accept the administration's recommendation in enacted legislation.
- The proposed anti-inversion provisions would apply to transactions completed after the date of enactment.
- Additionally, the proposal related to the limitation of section 1031 would be effective for exchanges completed in tax years beginning after December 31, 2021—apparently regardless of the date upon which the exchange may have begun.
- The proposal to replace the BEAT with the SHIELD would generally apply to tax years beginning on or after January 1, 2023. This date—one year later from most of the other corporate proposals—could be intended to provide flexibility related to the ongoing BEPS 2.0 negotiations at the OECD.

Energy and natural resources proposals

The Green Book also includes significant energy proposals, many of which were previously included in budget proposals made during the Obama Administration. The administration explains in the Green Book that its intent is to reduce the preferential treatment of the fossil fuels industry under the tax code, while providing incentives to promote more clean energy production and greater energy efficiency.

KPMG observation

The Biden Administration has set forth an ambitious long-term infrastructure and social support program. Congress might act on all or part of that program, or could add to it. The revenue-raising tax proposals set out in the budget are designed to offset the cost, over time, of the proposed increases in spending and tax incentives. Some proposals might face challenges in the legislative process and could be modified or eliminated during congressional consideration of possible legislation. Additional proposals could be added to potential legislation as well. Indeed, it would not be surprising if significant modifications were made to the Biden Administration's tax proposals if and when they are considered in Congress.

Fossil fuels proposals

Reform the taxation of international fossil fuel income

The administration's FY 2022 proposal would make several significant changes to the current rules on the taxation of international fossil fuel income, effective for tax years beginning after December 31, 2021.

Repeal current law exemption for foreign oil and gas extraction income (FOGEI) from global intangible low-taxed income (GILTI)

Section 951A requires a U.S. shareholder in a controlled foreign corporation (CFC) to include in income its share of the CFC's GILTI. Under section 951A(b), one component of the GILTI calculation is the shareholder's share of the CFC's net tested income. However, under the current law, section 951A(c)(2)(A)(i)(V) excludes FOGEI (as defined in section 907(c)(1)) from the definition of net tested income. The proposal would remove this exemption, thereby including FOGEI in the determination of a U.S. shareholder's GILTI inclusion. The effect of the proposal would be to put foreign oil and gas extraction on par with other industries for purposes of the GILTI inclusion.

Amend the definitions of FOGEI and foreign oil related income (FORI) to include income from shale oil and tar sands activity

Under section 901, a taxpayer generally may claim a credit against its U.S. income tax liability for the amount of any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or to any possession of the United States. Section 901(e) provides special rules that reduce a taxpayer's foreign tax credit for "excess" foreign taxes paid on foreign mineral income. Section 901(e) reflects Congress's concern that higher foreign tax rates on mineral production was being used to offset other foreign source income. Section 907 provides the specific rules for determining the section 901(e) limitation on a taxpayer's foreign tax credit. The section 907 rules look to the amount of foreign tax imposed on the taxpayer's FOGEI and FORI.

In defining FOGEI and FORI, section 907(c) refers to the extraction and related income derived from minerals from oil or gas wells without providing any additional guidance on the meaning of minerals for this purpose. However, section 1.907(c)-1(f)(1) of the regulations clarifies that the term minerals from oil or gas wells includes incidental impurities (for example, sulphur, nitrogen or helium) produced from the well, but does not include hydrocarbon minerals derived from shale oil or tar sands. Under this definition, the section 907 limitation for excess foreign taxes paid would not apply to the extraction of and related income from shale oil or tar sands.

The administration's proposal would amend section 907 to provide that hydrocarbon minerals derived from shale oil or tar sands are included in the section 907 calculation, and therefore subject to the section 901(e) limitation.

Amend the "dual capacity taxpayer" rules to codify the regulatory safe harbor

Under section 901, a taxpayer may generally claim a credit against its U.S. income tax liability (subject to the taxpayer's foreign tax credit limitation) for foreign levies that are compulsory payments made under the authority of a foreign jurisdiction to levy taxes and that are not in exchange for a specific economic benefit.

Taxpayers that are subject to a foreign levy and also receive a specific economic benefit from the foreign levying jurisdiction (i.e., "dual capacity taxpayers") may not claim a foreign tax credit for the portion of the foreign levy paid for the specific economic benefit. A common example of a dual capacity taxpayer would be an oil company that makes an upfront payment to a foreign country for the granting of a concession on oil and gas production and will also pay a royalty percentage of the produced oil in kind or in money. In addition to the royalty payments, the taxpayer is also subject to an income tax on its production in the foreign country. Under section 901, the payment of the royalty is not considered a creditable foreign tax.

However, the line between a foreign tax and a payment for a specific economic benefit is often blurred, making it difficult for taxpayers and the IRS to determine the amount of creditable foreign tax. Historically, the determination of whether a specific payment was a tax or for an economic benefit was made based on the facts and circumstances. As described in section 1.901-2A(a)(1) of the regulations, the key determination is whether the application of a levy is either different by its terms or different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers. The regulations place the burden of proof on the taxpayer to establish that a payment is properly treated as a tax.

As with any facts and circumstances test, the issue of when a payment should be considered a tax has been a source of tension between taxpayers and the IRS and has been litigated several times. The Tax Court has looked to several factors to consider in making the determination of whether a levy is a tax or a payment for an economic benefit, including:

1. Whether the new levy gives taxpayers subject to it expanded rights,
2. Whether the new levy is imposed based on negotiations between the government and companies engaged in extraction of natural resources or instead by unilateral governmental action,
3. Whether the levy can be imposed absent net profits, and
4. Whether the levy can be paid in kind or must be paid in cash.

See, e.g., *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999).

Section 1.901-2A(e) of the regulations also provides taxpayers with a safe harbor, whereby a taxpayer can apply a formula to determine the amount of a payment that will be excluded from the foreign tax credit, avoiding a possible conflict with an examination team. The safe harbor formula is set out in current regulations as follows:

(A – B – C) x (D/(1-D)) = the amount treated as a creditable tax

Factors in the formula are:

A. Gross receipts under the foreign law used to determine the levy;
B. Costs and expenses under the foreign law used to determine the levy;
C. The amount actually paid under the qualifying levy; and
D. The general foreign income tax rate expressed as a decimal.

The formula in the safe harbor is intended to approximate the tax that would have been levied on taxpayer that was not a dual capacity taxpayer. If a foreign country does not impose an income tax, the safe harbor method may still be elected, but the tax rate used in the formula will be the lesser of the foreign dual capacity levy rate or the U.S. corporate rate.

The administration's proposal would eliminate the facts and circumstances method and codify the safe harbor method for a dual capacity taxpayer to determine the portion of a foreign levy paid for a specific economic benefit. The proposal is ambiguous regarding whether a dual capacity taxpayer operating in a foreign country without a generally applicable corporate income tax would be disallowed a foreign tax credit for the entire levy, as included in prior legislative proposals and Senator Wyden's recent proposal. The Biden proposal states that it would "codify" the existing regulatory safe harbor, which would allow creditable foreign taxes based on the U.S. rate if the local jurisdiction does not have a generally applicable corporate income tax. Nevertheless, the Green Book describes the current regulatory safe harbor and the proposal itself only in terms of allowing tax credits based on the generally applicable local corporate tax rate. The proposal explains that codifying the safe harbor approach will prevent foreign hydrocarbon income from receiving preferential tax treatment relative to other industries.

As under the current regulations, the proposal also provides that any such rule for determining the amount of a foreign levy paid by a dual capacity taxpayer that qualifies as a creditable tax would not apply to the extent that it conflicts with any U.S. treaty obligation that specifically allows a credit for taxes paid or accrued on certain oil and gas income. Income tax treaties between the United States and the Netherlands, Norway, and the United Kingdom include relevant oil and gas extraction income tax credit provisions. For further context, it should be noted that Senator Wyden's proposed legislation also maintains the exception for treaty overrides.

KPMG observation

The administration's proposal is intended to prevent dual capacity taxpayers from receiving preferential treatment under the foreign tax credit rules by codifying the mechanical formula of the regulatory safe harbor. The benefit of the proposal is that mandating the safe harbor method could free up both taxpayer and IRS resources that otherwise would have been spent on examining the facts and circumstances of individual foreign levies. Together with the proposed changes to FOGEI described above, the proposed application of jurisdiction-by-jurisdiction computations in both the GILTI regime and section 904 foreign tax limitations could be expected to largely mute any impact that might otherwise result from the proposed changes to the dual capacity rules – as is illustrated by its estimated revenue impact of less than $200 million per year.

However, the elimination of the facts and circumstances test in favor of the simplified safe harbor method might in some contexts produce results that arguably are unfair. For example, the existing regulations contain an example explicitly concluding that a particular regime as applied to dual capacity taxpayers is a tax in its entirety under the facts and circumstances analysis. The administration's proposal does not provide any analysis (or even an assertion) that the conclusion in that example was inappropriate or should be reconsidered.

Eliminate fossil fuel tax preferences

The administration's FY 2022 proposal would repeal many of the tax preferences available to the fossil fuels industry. Many of these provisions have been a part of the tax code for many decades, and in some cases precede the modern tax system. Others represent a compromise position that was reached to end ongoing and costly disputes between taxpayers and the IRS over the proper treatment of particular expenses. These histories are worth noting because they highlight that there likely would be much work to be done in determining what rules would apply in the event of a repeal. Therefore, in addition to the revenue impacts estimated by the administration, if any eventual legislation includes these proposals without also providing guidance on the intended treatment going forward, the additional compliance burden placed on taxpayers and the IRS should be considered.

Repeal the section 43 enhanced oil recovery credit

The administration's proposal would repeal the section 43 credit for enhanced oil recovery (EOR) costs for tax years beginning after December 31, 2021.

The general business credit includes a 15% credit for eligible costs attributable to EOR projects located in the United States involving the application of specified tertiary recovery methods. The allowable credit may be phased out for a tax year if the reference price of oil published by the Treasury Department exceeds a statutory threshold price.

KPMG observation

For many years, higher oil prices caused the EOR credit to be completely phased out. However, as oil prices have fallen from peak levels, the EOR credit has been available in several recent years. For example, the EOR credit was available for calendar years 2016-2018. While the credit was phased out for calendar years 2019 and 2020, it is expected to be available again for calendar year 2021. If post-COVID-19 oil prices remain low, a repeal of the EOR credit could have a significant impact on oil and gas producers.

Repeal the section 45I credit for oil and gas produced from marginal wells

The administration's proposal would repeal the section 45I credit for oil and gas produced from marginal wells for tax years beginning after December 31, 2021.

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit generally has served as an incentive to continue to operate wells, despite low production volumes or where the wells primarily produce heavy oil. However, the allowable credit may be phased out for a tax year if the reference price of oil published by the Treasury Department exceeds a statutory threshold price.

KPMG observation

The statutory threshold price for the marginal well credit is set at a low enough level that the credit has been subject to significant phase out in recent years. For the 2020 calendar year, the credit amount is estimated to be approximately $0.60 per 1,000 cubic feet of natural gas and the credit for oil was completely phased out. As such, it is unlikely that the credit going forward would be a significant benefit, even if not repealed.

Repeal the ability to expense section 263(c) intangible drilling costs

The administration's proposal would repeal the section 263(c) deduction for IDCs for tax years beginning after December 31, 2021.

Section 263(c) and the regulations thereunder allow a deduction for all expenditures made by the holder of a working interest in a domestic oil and gas property for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. Generally, IDCs do not include expenses for items which have a salvage value or items related to the acquisition of the property. The deductibility of IDCs under section 263(c) is elective, meaning that taxpayers have the option of choosing to capitalize IDCs instead, recovering them through depletion or depreciation. Moreover, a taxpayer who elects to deduct IDCs has the additional option in any tax year of electing under section 59(e) to deduct a portion of its IDCs and capitalize the rest.

KPMG observation

The deductibility of domestic IDCs is one of the oldest provisions in the tax system, dating back to 1916. It has been a key component of the oil and gas tax rules for a century, and its repeal will have a significant impact on oil and gas producers. The administration's proposal estimates that the repeal of the IDC deduction will generate approximately $10.5 billion in additional tax revenue between FY 2022 and FY 2031, making it the largest revenue raiser of the fossil fuels "tax preferences" that the administration proposes to repeal. However, simply repealing such a well-established provision without also providing for the expected treatment of those expenditures going forward would leave substantial uncertainty for taxpayers (and likely the IRS) to sort out. IDC is an umbrella term that covers several categories of expenditures, some of which may still be deductible (such as wages), may be capitalized to depreciable equipment (and possibly eligible for bonus depreciation), or may be capitalized to the depletable basis of the property. Moreover, the percentage of a taxpayer's IDCs falling into each category may vary greatly depending on the location of the reservoir, particularly when comparing on-shore and off-shore drilling. The Treasury Department may find that providing guidance that helps draw lines between those categories would reduce the burden of a repeal on examination teams.

What is also left unclear in the proposal is what the administration's plan is with respect to foreign IDCs, and whether the administration might choose to replace section 263(c) with a rule similar to the existing rule for foreign IDCs. Under section 263(i), IDCs paid or incurred with respect to wells located outside of the United States are not deductible. However, a taxpayer has the option of either capitalizing foreign IDCs into the depletable basis of the oil and gas property or amortizing the foreign IDCs over a 10-year period. Given that no changes were proposed with respect to section 263(i), it is possible that a similar amortization option could be provided for domestic IDCs, which would also have the benefit of providing certainty on the treatment of domestic IDCs going forward.

Repeal the section 193 deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method

The administration's proposal would repeal the deduction under section 193 for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method for tax years beginning after December 31, 2021.

Section 193 provides that amounts paid or incurred for qualified tertiary injectants are deductible. Qualified tertiary injectants are used as a part of a tertiary recovery method to increase the recovery of crude oil, excluding any recoverable hydrocarbon injectants. The deduction may be subject to recapture upon a disposition of the property.

KPMG observation

The administration's proposal does not provide any guidance on the intended treatment of tertiary injectant expenditures following the possible repeal of section 193. Section 193 was enacted to clear up uncertainty as to the proper treatment of tertiary injectant expenditures, and it is hoped that further guidance would be provided when legislative text is eventually drafted. Specifically, query whether the cost of the tertiary injectants would be capitalized to the basis of the property and recoverable under cost depletion. Given the high cost of operating tertiary recovery projects, without a cost recovery mechanism for injectant expenditures these projects may no longer be economically viable for many taxpayers.

Repeal the exception to passive loss limitations under section 469(c)(3) for working interests in oil and natural gas properties

The administration's proposal would repeal the exception under section 469(c)(3) to the passive loss limitation rules for working interests in oil and natural gas properties for tax years beginning after December 31, 2021.

Generally, section 469 denies taxpayers the ability to deduct losses from passive activities. Where the taxpayer does not materially participate in a trade or business, section 469 requires losses from the business to be carried forward until the taxpayer has enough income from passive sources to offset them. However, section 469(c)(3) provides an exception to the general passive activity rules where a taxpayer holds a working interest in oil or gas property. Under section 469(c)(3)(A), the exception applies both where the taxpayer holds their share of the working interest directly and where the working interest is held through an entity such as a partnership (provided that the entity does not limit the taxpayer's liability with respect to the working interest). Therefore, as explained in section 469(c)(4), a taxpayer isn't required to meet the material participation rules in the case of an investment in a working interest in oil or gas property. The administration's proposal would appear to treat an investment in a working interest in oil or gas property on par with other passive investments.

Repeal percentage depletion on oil and gas wells

The administration's proposal would repeal the use of percentage depletion with respect to oil and gas wells for tax years beginning after December 31, 2021.

The basis in oil and gas property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion apparently would be the only method of determining a taxpayer's depletion deduction for oil and gas property.

KPMG observation

Percentage depletion on oil and gas property has been limited to independent producers and royalty owners since 1975. Presently, the independent producer and royalty owner exception is limited to taxpayers with a total share of production of 1,000 barrels of oil or natural gas equivalents per day for an individual, their spouse, and any minor children. Given the relatively low cap on a taxpayer's share of production in order to qualify for the independent producer exception, the administration's proposal is unlikely to have a meaningful impact on larger producers.

However, the elimination of percentage depletion may impact smaller outside investors in oil and gas properties, including those investing through funds, which have been an important source of capital for the industry. If the administration's proposal is adopted, the repeal of percentage depletion (along with many of the other oil and gas proposals discussed herein) could make the oil and gas sector a less attractive investment option and impact the ability to raise capital for future developments.

Repeal two-year amortization of geological and geophysical expenditures under section 167(h)

The administration's proposal would repeal the two-year amortization of geological and geophysical expenditures under section 167(h) for independent producers, and replace it with the same seven-year amortization period currently used by integrated oil and gas producers for tax years beginning after December 31, 2021.

KPMG observation

It is noteworthy that the administration chose to retain the favorable treatment afforded by section 167(h), albeit with the extended recovery period currently available to integrated producers, rather than simply repealing section 167(h) as they proposed with other oil and gas provisions. The enactment of section 167(h) was an attempt to settle an area of significant uncertainty and reduce the burden on examination teams. While section 167(h) hasn't eliminated all uncertainty in this area, it likely still provides sufficient value to taxpayers and government alike that the administration chose not to propose a repeal.

Repeal the ability to expense mine development expenditures under section 616 and mine exploration expenditures under section 617

The administration's proposal would repeal the election to deduct amounts paid or incurred for mine exploration under section 617 and mine development under section 616 for tax years beginning after December 31, 2021.

Under section 617 and section 616, a taxpayer is allowed a deduction both for the costs incurred in determining whether and where to mine an ore or mineral deposit as well as for the costs incurred in preparing the mine site for production. Under the existing law, if a taxpayer does not elect to deduct exploration and development costs, the amounts paid or incurred are capitalized to the basis of the mineral property and recovered through depletion. Presumably, if the administration's proposal were enacted, this would become the proper treatment of all exploration and development expenditures.

Repeal percentage depletion on hard mineral fossil fuels

The administration's proposal would repeal percentage depletion for hard mineral fossil fuels for tax years beginning after December 31, 2021.

The basis in mineral property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable mineral reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is a based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion apparently would be the only method of determining a taxpayer's depletion deduction for hard mineral property that produces what is considered a fossil fuel.

KPMG observation

The administration's proposal does not specify that it is intended to apply only to coal production. The introductory language to the section of the Green Book outlining the administration's fossil fuel proposals lists oil, gas, and coal (including lignite) production as its intended subjects. However, the description of the proposal itself states that it is aimed at "coal mines and other hard-mineral fossil-fuel properties," which raises the question of what other hard minerals would be considered fossil fuels and would be covered by this proposal.

Repeal capital gains treatment under section 631(c) for retained royalties on the disposition of coal or lignite ore

The administration's proposal would repeal capital gains treatment under section 631(c) for amounts realized in tax years beginning after December 31, 2021 from royalties received on the disposition of coal or lignite ore.

Under current section 631(c), a taxpayer who retains a royalty in connection with the disposal of coal (including lignite) or iron ore may treat the royalty payments as proceeds from the sale of the coal or iron ore. The result is that the royalty payments generate capital gain, rather than ordinary income. Moreover, despite being an economic interest in the coal or iron ore, the royalty income is not subject to depletion. Under the administration's proposal, future royalty payments on sales of coal (including lignite) would appear to generate ordinary income instead of capital gain. The proposal does not appear to impact the current treatment under section 631(c) for retained iron ore royalties.

KPMG observation

A retained royalty is an economic interest in the mineral, despite the treatment provided for by section 631(c). This raises the question of what the result would be if section 631(c) were repealed as proposed, but the administration were unsuccessful in repealing percentage depletion for coal. Does converting the section 631(c) retained royalty into a traditional economic interest then allow the taxpayer to take percentage depletion on the royalty income (assuming that all of the taxpayer's tax basis in the property had been recovered already, such that cost depletion would be unavailable)?

Further, section 631(c) treats a retained royalty as more akin to an installment sale of the mineral property than as a traditional royalty. This treatment may leave several questions unanswered. For example, does a possible repeal of section 631(c) for coal (including lignite) open the door for taxpayers simply structuring their transactions aiming for installment sale treatment? Would exam teams be burdened with determining when a series of sales payments are properly viewed as a royalty?

Modify the rules for publicly traded partnerships to remove income from fossil fuels from the definition of qualifying income

The administration's FY 2022 proposal would repeal the exemption from the corporate income tax for publicly traded partnerships (PTPs) with qualifying income and gains from activities relating to fossil fuels. The repeal is proposed to be effective for tax years beginning after December 31, 2026.

KPMG observation

PTPs generally are classified as corporations for tax purposes. However, section 7704 provides an exception for PTPs that derive at least 90% of their gross income either from industries that had traditionally organized as partnerships or from passive investment assets that the investors could have acquired directly. The natural resources extractive industries have been one of the activities that generate income that satisfies the 90% test, allowing natural resource PTPs to continue to qualify as passthrough entities under section 7704. In addition to the lack of a corporate-level tax on the business, investors in natural resources PTPs have benefitted from the flow through of depletion and depreciation deductions as an offset to their allocations of operating income. The public investors have received reliable distributions of the cash generated by partnership operations, with relatively small allocations of net tax income.

While several natural resources PTPs incorporated after the reduction in corporate rates, most have still found passthrough status to be an attractive way of raising capital for future acquisitions and development. If this proposal is enacted, particularly in combination with an increase in the corporate rates, query whether the natural resources PTP market itself may evaporate and whether many of the existing companies may find their operations no longer economically viable. However, with a proposed effective date five years in the future, the industry would have a long lead time to prepare.

Limit section 1031 like-kind exchanges

The administration's FY 2022 proposal would substantially reduce the amount deferrable under the like-kind exchange rules of section 1031 for exchanges completed in tax years beginning after December 31, 2021.

The proposal is not to repeal section 1031, and the like-kind exchange rules would still be applicable to exchanges of real property held for productive use in a trade or business or for investment. However, the aggregate amount of gain that could be deferred by a taxpayer under the proposal would be limited annually to $500,000 (or $1 million in the case of married individuals filing a joint return).

Any gain realized on an exchange in excess of the $500,000 limitation would be recognized in the tax year in which the property was transferred. Accordingly, if a taxpayer engages in a deferred exchange that straddles two tax years, the gain would be triggered in the first tax year when the relinquished property is transferred rather than the second year when the exchange is completed. This treatment would represent a change from current law, since currently gain recognized in a deferred exchange is generally determined under the installment method.

KPMG observation

While the administration's proposal does not specifically target the oil and gas industry, it would have a significant impact on certain oil and gas properties. Oil and gas unitizations, poolings, and communitizations are treated as like-kind exchanges for federal income tax purposes. Rev. Rul. 68-186, 1968-1 C.B. 354. "[T]he owners of the property have in effect exchanged their separate interests in their leases for undivided interests in the whole, with the result that all the interests of the taxpayer in the unit become one property." H. Rep. No. 88-749 (1963), reprinted in 1964-1 (pt. 2) C.B. 125, 216. Note that section 614(b)(3)(A)(i) has a unique supremacy clause regarding the unitization and pooling rules for all purposes of the income tax ("shall be treated for all purposes of this subtitle as one property"). For example, on federal offshore properties a successful well must be drilled in order to enter the unit, and there may be multiple unit expansions as additional wells are drilled. Such units would exceed multiple $500,000 amounts many times over. Therefore, the administration's proposal would likely have a chilling effect on all future unitization arrangements.

Regarding the impact on a taxpayer's income tax bases in various states, because states generally adopt federal income as the starting point for computation of the state income tax base, if a state automatically conforms to the Code and this federal change is made, the state would correspondingly recognize gain from exchanges with amounts exceeding the federal thresholds. Similarly, if the proposed federal rule is enacted, and a state with static conformity updates its rules to follow the federal rule change, then a taxpayer in this state would also recognize gain from exchanges with amounts exceeding the federal thresholds. If a state with static conformity does not update its conformity to the Code, then gain from an exchange may continue to be deferred for the income tax base in that state. The determination of the overall impact on the exchanging parties may vary by state if the properties involved in the exchange are located in multiple states because certain of these states may follow the proposed federal recognition rules while other states may continue to permit the deferral.

The administration proposes to have this change effective for exchanges completed in tax years beginning after December 31, 2021. By focusing on the date on which an exchange is completed, the administration's proposal could apply to exchanges that begin prior to January 1, 2022. In particular, the proposal could impact any like-kind exchange that begins on or after July 5, 2021 if the taxpayer relies on the entire 180-day exchange period for completing the exchange.

Repeal the exemption from the section 4611 oil spill liability trust fund excise tax for crude oil derived from bitumen and kerogen-rich rock

The administration's proposal would repeal the exemption from the section 4611 Oil Spill Liability Trust Fund excise tax for crude oil derived from bitumen and kerogen-rich rock for tax years beginning after December 31, 2021.

Section 4611 imposes an excise tax on crude oil and petroleum products to help fund the Oil Spill Liability Trust Fund. For purposes of section 4611, the definition of crude oil has been interpreted as excluding "synthetic" petroleum, such as oil produced from bituminous deposits or tar sands. The administration's proposal would clarify that oil derived from bitumen and kerogen-rich rock is considered crude oil under section 4611, and therefore subject to the excise tax.

Modify section 169 to expand eligibility for preferential amortization period for certain air pollution control facilities

The administration's proposal would expand the eligibility for accelerated amortization for air pollution control facilities for tax years beginning after December 31, 2021.

Section 169 provides for an 84-month recovery for certain pollution control facilities placed in service at coal-fired power plants after April 11, 2005. The administration's proposal intends to expand the eligibility under section 169 to cover new identifiable treatment facilities which are used, in connection with a plant or other property, to abate or control water or atmospheric pollution by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The administration's concern is that, without an expansion of section 169 eligibility, these facilities would be subject to a 39-year recovery life.

Alternative energy and energy efficiency proposals

Extend and enhance renewable and alternative energy incentives

Wind energy

Under current law, a taxpayer has to begin construction on an onshore wind facility by December 31, 2021 to qualify for the production tax credit (PTC). The credit rate for onshore wind facilities is in the process of phasing down and the full PTC rate is only available for projects that began construction prior to 2017. Projects that begin construction in 2017 are eligible for 80% of the otherwise eligible PTC rate. Projects that begin construction in 2018 are eligible for 60% of the otherwise eligible PTC rate. Projects that begin construction in 2019 are eligible for 40% of the otherwise eligible PTC rate. Projects that begin construction in 2020 or 2021 are eligible for 60% of the otherwise eligible rate.

A taxpayer may elect the investment tax credit (ITC) in lieu of the PTC for wind facilities, but the ITC rate phases down on a schedule comparable to the PTC.

A taxpayer that begins construction on an offshore wind farm after 2016 and before 2026 is eligible to claim an ITC at the full statutory credit rate or 30%.

Solar energy

Under current law, a taxpayer that begins construction of a solar energy facility in 2020-2022 is eligible for a 26% ITC credit. Further, a taxpayer that begins construction of a solar energy facility in 2023 is eligible for a 22% ITC. Projects that begin construction after that or that are placed in service after 2025 are eligible for a 10% ITC.

Other renewables

The PTC is available for geothermal, biomass, trash combustion, landfill gas, hydropower and wave, tide power if construction of the project begins prior to 2022.

As with wind facilities, taxpayers may elect the ITC in lieu of the PTC.

Further, fuel cell powerplants, fiber optic solar property, waste energy recovery property and small wind projects qualify for a 26% ITC rate if construction begins in 2021 or 2022, and a 22% ITC rate if construction begins in 2023. No credit is available for projects that are not placed in service by the end of 2025 or that begins construction after 2023.

Finally, there is a 10% ITC for combined heat and power property, microturbines and geothermal heat pumps that applies if construction begins prior to 2024.

Residential energy efficient property

For individuals, a credit is available for the cost of solar electricity property, solar water heating property, fuel cell property, small wind energy property, geothermal heat pump property and biomass fuel property installed in a residence. The current credit rate is 26% for property placed in service in 2021 and 2022. The rate is scheduled to phase down to 22% in 2023 and the credit is unavailable thereafter.

Proposal

Under the administration's FY 2022 proposal, the PTC would be available for otherwise PTC-eligible projects if they begin construction after 2021 and before 2027, and the full PTC rate would be available. For projects that begin construction after 2026, the PTC rate for eligible facilities would phase out over five years, reduced by 20% each year.

The proposal would restore the ITC for projects that begin construction after 2021 and before 2026 at their full statutory rate. For projects that begin construction after 2026, the ITC rate for eligible property would phase out over five years, reduced by 20% each year.

Starting in 2022, the proposal would expand the ITC to include stand-alone energy storage technology that stores energy for conversion into electricity and has a capacity of not less than 5 kilowatts.

Taxpayers could elect a direct pay option in lieu of the PTC or ITC.

The proposal states that the administration will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

The credit for residential energy efficient property would also be extended to its full statutory rate for property placed in service after 2021 and before 2026, The proposal would also expand the definition of eligible property to include qualified battery storage technology of at least three kilowatts of capacity installed in a residence. For projects that are placed in service after 2026, the ITC rate for eligible property would phase out over five years, reduced by 20% each year.

If enacted, the proposal would be effective after 2021.

KPMG observation

The administration's proposal would significantly enhance and simplify the ITC and PTC. Most significantly, the proposed direct pay option could change the landscape for developing and financing renewable energy facilities. In many cases, developers of these projects do not have sufficient tax liability to use the available tax credits and must rely on tax equity investors. Tax equity structures are complicated and there is a limited pool of investors so the direct pay option could remove barriers and simplify development for many projects.

The proposal does not provide much additional detail on how direct pay would operate. Direct pay raises various questions, including but not limited to the following:

- Whether there would be a pre-approval or other validation requirements, similar to the section 1603 cash grant in lieu of tax credit program enacted under the American Recovery and Reinvestment Act of 2009.
- Whether the election and payment would be made at the partnership level, which would simplify the availability of the payment for projects owned by partnerships (but also potentially raise questions about the appropriate partnership tax treatment of the payment).
- Whether the proposal would impact the applicability of the passive activity and at-risk rules, which currently limit the benefit of ITCs and PTCs to individual investors.

A direct pay option for the PTC and ITC and other credits is also featured in recently introduced legislation and appears to be a consistent feature of the administration's and some Democratic lawmakers' infrastructure agenda.

In addition, the effective date of the proposal is unclear. As described, ITC and PTC eligibility is generally dependent on the date construction begins, however, the proposal just states it is "effective after 2021." It is unclear, for example, whether the proposal is intended to be effective (and direct pay and higher credit rate available) for projects placed in service after 2021, even if currently under construction.

Provide a tax credit for electricity transmission investments

The administration's FY 2022 proposal includes a new 30% ITC for high voltage transmission lines and associated equipment meeting certain criteria, specifically a minimum voltage of 275 kilovolts and a minimum transmission capacity of 500 megawatts. Under the proposal, taxpayers could elect a direct pay option in lieu of the tax credit. The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

If enacted, the proposal would be effective for property placed in service after December 31, 2021, and before January 1, 2032.

KPMG observation

Transmission lines and associated equipment are often owned by regulated utilities so this proposal could raise issues related to how to structure investment in, and ownership of, these assets in order to best realize the benefit of the credit. For instance, regulated utilities are subject to the normalization rules which require regulated utilities to spread the benefit of investment tax credits and accelerated depreciation over the useful life of an asset. The normalization rules are intended to allow utilities to use the economic benefit of the tax incentives to make additional investments, rather than immediately pass the benefits on to ratepayers. It is argued, however, that the rules often have the effect of making it less cost effective for utilities to make their own ITC eligible investments in comparison to unregulated entities. This proposal does not include an election to opt out of normalization, which could have made this incentive more meaningful for many regulated utilities. A similar credit proposed in Chairman Wyden's "Clean Energy for America Act" does include a normalization opt out.

Provide allocated credit for electricity generation from existing nuclear power facilities

The administration's FY 2022 proposal includes a new allocated production tax credit for electricity produced from existing nuclear power facilities. The proposal describes a competitive application process under which facilities would apply for an allocation of credits based on, among other factors:

- Demonstration of a good operation and safety record,
- Demonstration that the facility is facing financial operating losses and that future projections include continued losses, and
- Demonstration that emissions of various air pollutants would increase if the facility ceased operations.

A credit allocation round would be held every two years and up to $1 billion in credits would be to available to be allocated in each year. Under the proposal, taxpayers will also have to identify the amount of credit per megawatt-hour of generation that would be sufficient for them to continue operations during that two-year period.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

The proposal would be effective after December 31, 2021. The first two-year crediting window would commence on January 1, 2022, and the last crediting window would commence on January 1, 2030.

KPMG observation

Under current law, section 45J provides an allocated credit for production from new nuclear capacity, while this proposal is intended to incentivize the continued operation of existing nuclear facilities. The mechanics of this credit proposal, while obviously carefully and specifically tailored to meet its intended purpose, could prove difficult to implement because of the frequent allocation rounds and specific eligibility determinations.

Establish new tax credit for qualifying advanced energy manufacturing

The administration's FY 2022 proposal would extend and expand the qualified advanced energy property (QAEP) credit.

The QAEP credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind and other renewable energy component property, electric grids, carbon dioxide capture and sequestration property, and plug-in electric vehicles and component parts, among other eligible property. QAEP credits were first enacted as part of the American Recovery and Reinvestment Act of 2009, and $2.3 billion in QAEP credits were originally authorized. All of the credits were allocated by Treasury in two separate allocation rounds.

The administration's FY 2022 proposal would modify the section 48C credit by authorizing $10 billion in additional credits and expanding the eligibility criteria. Under the proposal, investments in additional categories of projects such as certain industrial facilities, recycling equipment, and energy storage would now qualify for the credit. Of the $10 billion in additional credits, $5 billion would be specifically allocated to projects in coal communities.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

Applications for the additional 48C tax credits would be made during the three-year period beginning on the date on which the additional authorization is enacted. The proposal would be effective after December 31, 2021.

KPMG observation

The proposed direct pay option would allow the section 48C credit to more effectively benefit the recipients, many of which would be new ventures with little or no tax liability. And unlike the ITC or PTC, the section 48C credit generally has not been monetized through tax equity investment. This proposal could change that.

Establish tax credits for heavy- and medium- duty zero emissions vehicles

The administration's FY 2022 proposal includes a new business tax credit for new medium- and heavy-duty zero-emission vehicles, including battery electric vehicles and fuel cell electric vehicles. Eligible vehicles would be those listed under Classes 3 through 8 of the Federal Highway Administration's vehicle classification system. This would be an expansion of the current tax credit under section 30D that only applies to passenger vehicles and light-duty trucks.

For vehicles acquired for use or lease by the taxpayer, the credit would range from $25,000 - $120,000 during 2022-2024 (depending on the class of the vehicle), with a phasedown to $10,000 - $100,000 during 2027, with a complete phase-out beginning in 2028. Each class of vehicle from Class 3 to Class 8 would have a separate phasedown schedule.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism. The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

KPMG observation

The current section 30D credit has a phasedown on a per-manufacturer basis, with the credit phasing down once a single manufacturer has sold 200,000 vehicles. It is unclear whether there would be a similar phasedown for heavy- and medium-duty vehicles on top of the annual phasedown.

Provide a production tax credit for low-carbon hydrogen

The administration's FY 2022 proposal would provide a new production tax credit when hydrogen is produced under the following two methods:

- Hydrogen is produced using zero-carbon emissions electricity—likely limited to renewables or nuclear energy—and using water as a feedstock or
- Hydrogen is produced using natural gas as a feedstock and with all the carbon emitted in the production process being captured and sequestered.

The credit would be available for each kilogram of qualified low-carbon hydrogen:

- Produced by the taxpayer and
- For an end-use application in the energy, industrial, chemicals, or transportation sector.

The credit would be available during a 6-year period beginning with the date the facility is placed in service.

The initial credit rate would be $3.00 per kilogram of hydrogen between 2022 and 2024 and $2.00 per kilogram between 2025 and 2027. The credit would be indexed annually for inflation beginning after the facility was placed in service.

Taxpayers would have the option to elect a direct pay option in lieu of the tax credits.

The hydrogen may be sold to an unrelated third party or, if directly consumed by the taxpayer that owns the facility, the production must be independently verified.

Construction of an eligible facility must begin prior to 2027.

The proposal states that is will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

If enacted, the proposal would be effective after 2021.

Extend and enhance energy efficiency and electrification incentives

Under current law taxpayers can claim a variety of deductions and tax credits for investments in energy efficiency property and improvements for their homes and business.

Current law incentives include:

- *Section 25C* – provides a tax credit for certain expenditures to improve the energy efficiency of a taxpayer's principal residence. Two types of property qualify for the credit: (i) Qualified Energy Efficiency Improvements; and (ii) Residential Energy Property Expenditures. The section 25C credit is equal to the sum of 10% of the cost of qualified energy efficiency improvements and eligible costs for residential energy property expenditures, subject to a limit of a $500 nonrefundable tax credit for the taxpayer's lifetime. Under current law the section 25C credit will expire December 31, 2021.

- *Section 45L* – provides a tax credit for the construction of new energy efficient homes that are purchased on or before December 31, 2021. The section 45L credit is $2,000 per dwelling unit, generally.

- *Section 179D* – provides a tax deduction for energy efficient commercial building property. The maximum allowable section 179D deduction is $1.80 per square foot. This deduction was made permanent in 2020.

The proposal would provide for the following extensions and expansions with respect to these three incentives, and would add a new credit for mechanical insulation labor costs:

- *Section 25C* – would extend the credit five years and increase the lifetime limit to $1,200; it would also increase the credit rate to 15% for qualified energy efficiency improvements.

- *Section 45L* – would increase the credit to $2,500 and extend the credit five years to the end of 2026.

- *Section 179D* – would increase the maximum section 179D deduction per square foot up to $3.00 per for qualifying property placed in service beginning in 2022.

- *Mechanical insulation labor costs* – would create a new general business tax credit for qualifying mechanical insulation labor costs. The credit would be 10% of such costs. Such costs would include the labor cost of installing mechanical insulation property, including insulation materials, and facings and accessory products, for a depreciable mechanical system.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

KPMG observation

These provisions generally would extend and expand three current energy efficiency tax incentives. The inclusion of these extension/expansion provisions was expected.

The mechanical insulation labor cost credit would be new to the tax code.

Expand and enhance the carbon oxide sequestration credit

The administration's FY 2022 proposal would extend and modify the section 45Q credit for carbon oxide sequestration.

Current law section 45Q allows credits to taxpayers who capture and sequester qualifying carbon oxide. The amount of the credit depends on how the capture carbon oxide is used. For carbon oxide disposed of in permanent storage and not used in an enhanced oil recovery (EOR) project, the credit increases to $50 per metric ton by 2026 and is adjusted for inflation in later years. For carbon oxide that is used as a tertiary injectant in an EOR project or utilized in a commercial product or process, the credit increases to $35 per metric ton in 2026 and is adjusted for inflation in later years.

Under section 45Q, facilities must meet certain minimum capture thresholds in order to claim the credit. For qualified facilities other than electric generating facilities, taxpayers generally must capture and sequester 100,000 metric tons of carbon oxide per tax year. For electric generating facilities, taxpayers must capture and sequester at least 500,000 metric tons of carbon oxide per tax year. A lower threshold of 25,000 metric tons is available if the carbon oxide is deployed in utilization projects. Qualified facilities must begin construction by January 1, 2026. Taxpayers may claim these credits for a 12-year period from the date the carbon capture equipment was originally placed in service.

The administration's FY 2022 proposal would extend the beginning of construction deadline by five years, such that qualified facilities must begin construction by January 1, 2031.

The proposal would also provide enhanced credit rates for carbon oxide captured in certain industrial processes. Specifically, the proposal would provide an additional $35 per metric ton for carbon oxide which is captured from sectors such as cement production, steelmaking, hydrogen production, and petroleum refining and permanently disposed of in secure geological storage. The additional $35 is not adjusted each year. For example, the total per ton credit for these types of projects would be $85 in 2026.

The proposal would also provide an enhanced credit for direct air capture projects. An additional $70 per metric ton of qualified carbon oxide would be available for qualified carbon oxide that is disposed of in secure geological storage. The additional $70 per-ton additional credit is not adjusted each year. For example, the total per-ton credit for these direct air capture projects would be $120 in 2026.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

If enacted, the proposal would be effective after December 31, 2021.

KPMG observation

The changes to section 45Q included in the administration FY 2022 proposal likely would be welcomed by the investors in these projects. The election to receive a cash payment in lieu of a tax credit would be particularly meaningful. As previously observed, a direct pay option for energy tax credits would change the landscape and minimize the need to seek outside tax equity investors. For section 45Q, the sheer volume of potential tax credits available for these projects almost necessitates the use of tax equity, however, typical tax equity investors have been hesitant to jump in for a variety of reasons including novel technology, offtake and storage uncertainty, and commodity price risk. A direct pay section 45Q tax credit would make these projects significantly less complicated to finance. Note, however, that the proposal's effective date is not specific about how it would apply or interact with the beginning of construction deadline. For instance, it is not clear whether the direct pay and the enhanced credit amounts would be available to a project which started construction in 2020 but will be placed in service in 2022. Finally, this proposal would not make changes to the minimum capture thresholds under current law section 45Q. The current law minimum capture thresholds have proven difficult to satisfy for some projects.

Extend and enhance the electric vehicle charging station credit

Under current law, taxpayers are eligible to claim an income tax credit for up to 30% of the cost of electric vehicle recharging stations. The credit is capped at $30,000 per location per year for business taxpayers and $1,000 for recharging stations installed at an individual's residence. The credit is not available for recharging stations placed in service after 2021.

The proposal would make five significant changes to the credit. It would:

- Increase the cap on the business credit;
- Remove the "per location" limit for the business credit;
- Extend the credit five years (to 2026);
- Allow business taxpayers to elect a cash payment in lieu of the general business credit; and
- Limit the credit to investments that meet "strong labor standards." (see below)

For business taxpayers, the credit cap would be increased from $30,000 to $200,000. Thus, a single retail location that had, for instance, installed four recharging stations at one location could potentially claim up to an $800,000 credit. Whereas before, the combination of the credit cap and the "per location" rule would have limited that taxpayer to a $30,000 credit in total for that location.

The administration's proposal states that the administration will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

If enacted, the proposal would be effective for charging stations placed in service after 2021.

Provide tax incentives for sustainable aviation fuel

For periods beginning after December 31, 2021 and before January 1, 2028, the administration's FY 2022 proposal would introduce:

- A production tax credit of $1.50 per gallon for sustainable aviation fuel that achieves at least a 50% reduction in emissions relative to conventional jet fuel.
- A supplementary credit of up to $0.25 per gallon, available on a sliding scale dependent on the degree of emission reduction.

Currently, there is no income tax credit for sustainable aviation fuel production facilities or property. However, sustainable aviation fuel that is biodiesel (including renewable diesel) is eligible for the $1.00 per gallon biodiesel excise tax credit, which is set to expire on December 31, 2022.

To qualify for the new tax credit, the administration's proposal would require an emissions reduction certification. The supplementary credit would be calculated at a rate of $0.01 for every two percentage points above the 50% reduction baseline. Therefore, sustainable aviation fuel with a 50% emissions reduction relative to conventional jet fuel would receive a $1.50 per gallon credit, while fuel with a 100% emissions reduction would receive a $1.75 per gallon credit. The administration's proposal would pair the credits with certain labor standards.

KPMG observation

Absent limiting language, producers of sustainable aviation fuel may be eligible for the $1.00 per gallon biodiesel credit, the $1.50 sustainable aviation fuel credit, and the supplementary credit for qualifying fuel produced in 2022.

Reinstate superfund excise taxes and modify oil spill liability trust fund financing

For periods beginning after December 31, 2021, and before January 1, 2032, the administration's FY 2022 proposal would reinstate at double the previous rates the following Superfund excise taxes that were imposed prior to 1996:

- An excise tax on domestic crude oil and imported petroleum products at a rate of $0.097 per barrel (oil spill tax).
- An excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton (chemical excise tax).
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

Currently, the oil spill tax is imposed at a rate of $0.09 per gallon on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. Crudes such as those produced from bituminous deposits and kerogen-rich rock (e.g., tar sands) are not treated as crude oil or petroleum products for purposes of the oil spill tax. The oil spill tax is dedicated to the Oil Spill Liability Trust Fund. The Customs drawback statute (Title 19 U.S.C. (Customs Duties) section 1313) has been administratively interpreted to allow drawback of the oil spill tax when products subject to this tax are exported. The administration's proposal would extend application of the oil spill tax to crudes such as those produced from bituminous deposits and kerogen-rich rock. For periods after December 31, 2021, the proposal would also prohibit a drawback of the tax under the Customs drawback statute (19 U.S.C. 1313) when products subject to the tax are exported.

The revenues from the chemical excise tax and tax on imported substances would be dedicated to the Hazardous Substance Superfund Trust Fund.

KPMG observation

In 2020, a U.S. district court held that the oil spill tax violates the Export Clause of the Constitution when imposed on domestically produced crude oil that is exported from the United States if, before such exportation, the oil spill tax had not already been imposed on it. The United States has appealed this opinion to the 5th Circuit. Depending on the outcome of the litigation, the administration's proposal might have no effect on untaxed exported crude.

Proposal to provide a disaster mitigation credit

The administration's FY 2022 proposal includes a new nonrefundable tax credit for homeowners and businesses equal to 25% of qualified disaster mitigation expenditures, capped at $5,000. The new credit would begin to phase out for individuals with an adjusted gross income (AGI) of $85,000 ($170,000 for joint filers) and for businesses when the business has gross receipts above $5 million. The credit would only be available in areas where a federal disaster declaration has been made (or areas adjacent to such areas) within the preceding 10-year period.

The purpose of this credit is to incentivize disaster damage mitigation, as current law does not provide any tax benefits for damage prevention. According to the proposal, mitigation has been shown to provide a great amount of value; for every $1 of mitigation expenditures, it is estimated that $4 of rehabilitation costs post-disaster can be avoided.

KPMG observation

It is not clear how much the credit would incentivize mitigation activities given (i) the relatively low phaseout thresholds for individuals and businesses and (ii) the relatively low maximum value of the credit.

Additionally, the entire United States is currently under a federal disaster declaration due to the COVID-19 pandemic. The provision appears to be drafted for typical natural disaster mitigation; thus, it is unclear whether the entire country would satisfy the "prior 10-year" requirement due to the federal disaster declaration for COVID-19.

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