Tax equity investment, energy and low-income housing under Pillar 2

Summary

The OECD reached an international agreement to implement a 15 per cent global minimum tax on the earnings of multinational enterprises (the framework known as ***pillar 2***). The pillar 2 rules create a top-up tax to be applied on profits in any jurisdiction whenever a taxpayer's effective tax rate (***ETR***), determined on a jurisdictional basis, is below the minimum 15 per cent rate. Some U.S. multinationals have raised concerns that the top-up tax will deprive them of the economic benefit of various U.S. business tax credits by allowing a non-U.S. jurisdiction to impose the tax on one of their non-U.S. affiliates if the tax credits push the group's U.S. ETR below 15 per cent.

That scenario would deprive the multinationals of the tax benefit Congress intended by creating those tax credits, and it would allow the offsetting tax revenue to be collected by non-U.S. jurisdictions that impose the top-up tax. Those concerns may be adequately addressed for some tax credit investments under the existing pillar 2 rules, but they may remain for others.

When a multinational earns tax credits from a joint venture that it does not consolidate, and its percentage interest in the vehicle is neither too high nor too low for some thresholds, the tax credit investment might not be affected by pillar 2. Tax credit investments that do not satisfy these conditions may still be susceptible to pillar 2 offsetting the tax credit benefit.

Under pillar 2, "qualified refundable tax credits," which are refundable in cash within four years of meeting the conditions, are recharacterized as increasing above-the-line earnings, and their effect in reducing corporate taxes is ignored in calculating a taxpayer's ETR. By contrast, tax credits that are non-refundable (such as U.S. research and development, clean energy, and low-income housing tax credits) are treated as reducing corporate taxes and depressing the ETR of investors earning those credits. The intended incentives of the credits would be blunted if they were offset by top-up tax under pillar 2.

Treasury has suggested that, because of the characteristics of common structures for investing in projects that are allocated clean energy and low-income housing tax credits, these credits should not be affected by pillar 2. This appears plausible based on an analysis of the OECD's model rules. Treasury is also looking at how to ensure that these credits remain available. The Build Back Better Act (H.R. 5376) legislative proposals to allow "direct payment" of specific clean energy credits could assist U.S. taxpayers if the legislation is passed.

Tax equity investment structures

For large U.S. taxpayers, investments in renewable energy and low-income housing projects are commonly structured as limited partnerships, or limited liability companies classified as partnerships for U.S. federal income tax purposes. Their role in these structures is referred to as "tax equity." Tax equity investors acquire an ownership interest in the renewable energy or housing project, and this structure passes the project's income, loss, and tax credits through to the investors in proportion to that ownership interest for U.S. tax purposes.

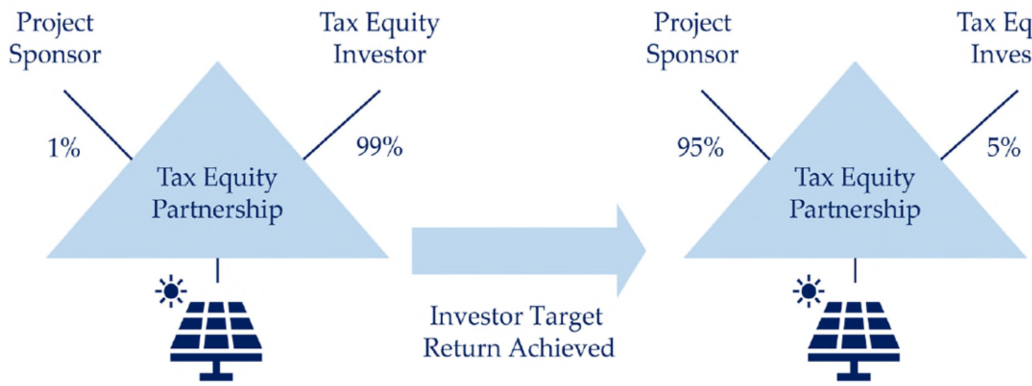
There are several structures that can be used, but renewable energy projects are often structured as "partnership flip" transactions, in which a tax equity investor and "sponsor" (typically a project developer) own the partnership vehicle in proportions that change over time.[1] The cash flow waterfalls of tax equity partnerships are complex. However, to give a simplified example, the structure may allocate 99 per cent of income, loss, and tax

[1] There are other structures, including sale and leaseback variants, but they are less common.

credits to the investor until the project achieves a target internal rate of return for the investor, at which point the tax equity investor's allocation may drop to 5 per cent.[2]

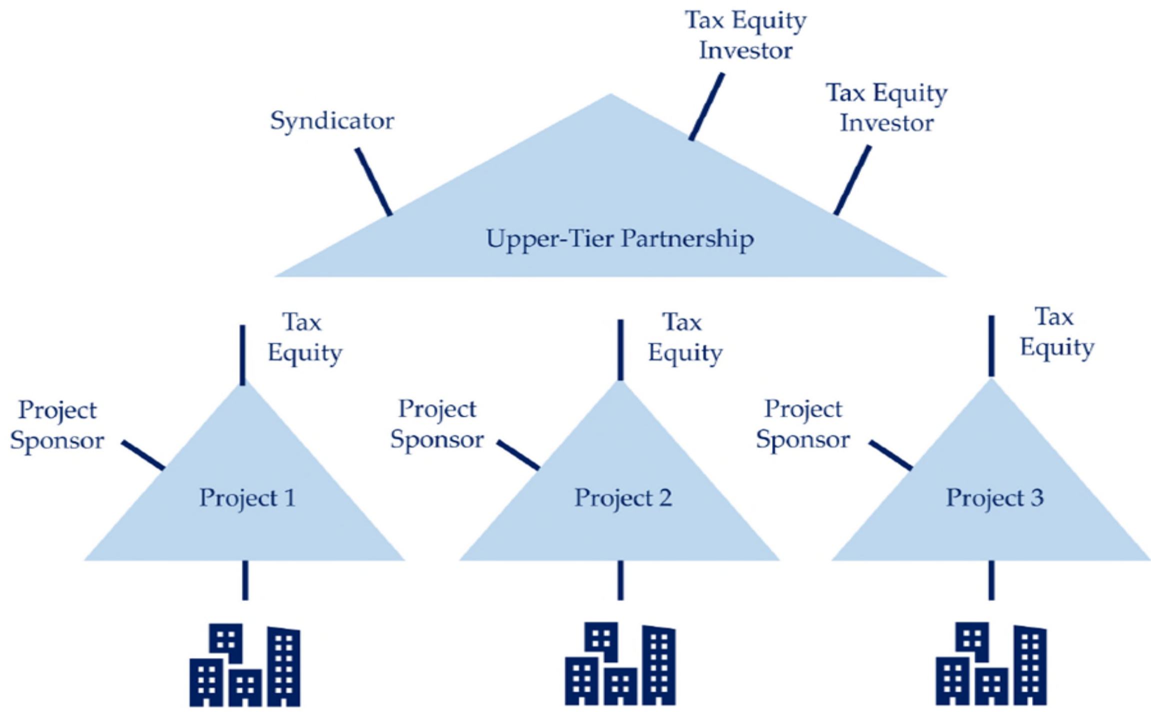
The sponsor may also have an option to buy the investor's remaining interest. This structure allows the tax credits from the project to flow to the tax equity investor without it having to maintain a significant ownership interest in the long term and allows the sponsor to raise cheaper financing for the project while retaining control over its management and operations. Similar partnership-based structures are used for investments in low-income housing projects.

Figure 1. Simplified Example of 'Partnership Flip' Structure



Especially for low-income housing, tax equity investors may alternatively participate in funds that aggregate a multitude of projects into a diversified portfolio, through which tax equity investors can more easily deploy capital at scale. Those funds are referred to as "upper-tier partnerships" and are managed by a syndicator.

Figure 2. Example of 'Upper-Tier Partnership' Structure



[2] The IRS has provided guidelines regarding ownership interests, risk exposure, capital contributions, and purchase and sale rights for partnership flip transactions in Rev. Proc. 2007-65, IRB 967.

Tax credits under Pillar 2

The role of tax equity investors in U.S. renewable energy and low-income housing projects stems from the fact that the "general business credits" that these projects generate have (with few exceptions) been non-refundable.[3] In other words, a taxpayer with "capacity" must invest in the project to fully obtain the value of the tax incentive granted by Congress. There are sound reasons why the incentives have been structured this way; non-refundable tax credits are generally thought to be more resistant to abuse and fraud than refundable credits or cash grants.

As multinationals now look toward implementation of the OECD's pillar 2 rules, a notable feature is that there is generally no allowance for government incentives in the form of non-refundable tax credits.[4] By contrast, so-called qualified refundable tax credits, which are refundable in cash within four years of meeting the conditions, are recharacterized as nontax government grants, meaning they are treated as increasing above-the-line earnings, and their effect in reducing corporate taxes is otherwise ignored in calculating the pillar 2 jurisdictional ETR.[5]

That leaves taxpayers in receipt of non-refundable tax credits with a distinctly *worse* treatment under pillar 2. The incentive means they are treated as paying correspondingly less "covered tax," which could push their jurisdictional ETR below the 15 per cent minimum, exposing the multinational to a top-up tax liability. Any such top-up tax liability would effectively reverse and offset the intended tax incentive.

Unsurprisingly, this has led to outcry from taxpayers in the United States that have pointed out that the pillar 2 rules not only undermine the incentives Congress had intended to grant, but worse, they allow *other countries* to collect the offsetting top-up tax: "These foreign taxes would infringe upon U.S. sovereignty, undermine the effectiveness of federal tax incentives designed to achieve important social, environmental, and economic policy goals, and (to the extent U.S. companies continue to invest in these activities) enrich foreign governments at the expense of the United States."[6]

The thinking here is that if the United States does not collect a qualified domestic minimum top-up tax offsetting those incentives itself, other countries will in principle collect the tax either under pillar 2's "income inclusion rule" (in the case of a foreign-parented group with U.S. operations) or "undertaxed profits rule" (***UTPR***) (in the case of a U.S.-parented group with foreign operations). Foreign UTPRs are therefore the focus of the ire of U.S.-headquartered taxpayers.

Treasury commentary on Pillar 2

The Biden administration proposed legislative measures in its fiscal 2023 budget plan that would implement the OECD's pillar 2 framework on global minimum corporate tax in the United States. Treasury accompanied the budget plan with explanations of the proposals in what is commonly referred to as the green book.[7] Neither the budget plan nor the green book explain how the benefits of non-refundable tax credits would be preserved.

Recently, however, Treasury tax policy official Lily Batchelder offered a technical observation as a potential "fix":

> For example, we have heard concerns about the potential impact of other countries' UTPRs for some taxpayers that invest in projects that give rise to the low-income housing tax credit, clean energy credits, and the new markets tax credit. But because of the way those investments are structured and accounted for, the income or loss and the income tax consequences of those investments typically will be excluded from the effective tax rate calculation, so those credits generally should not be impacted by UTPRs.[8]

Treasury official Michael Plowgian, speaking on a separate panel, was also reported as noting that credits that arise from holding investments accounted for under the equity method of accounting are not considered in determining the ETR of a taxpayer, and that Treasury intends to work with Congress to preserve the benefits of

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[3] U.S. Internal Revenue Code, Section 38(c).
[4] Accelerated depreciation for capital investment in tangible assets is accommodated by the deferred taxes rules and the exception for recapture exception accruals in article 4.4.5(a) of the OECD's pillar 2 model rules, so depreciation elements of the tax benefits for investors are not generally a concern. Other allowances for investment in the pillar 2 model rules — notably, the substance-based income exclusion — are not particularly strong and do not align with U.S. general business tax credits.
[5] Under article 4.1.2(d) of the OECD's pillar 2 model rules, qualified refundable tax credits that would otherwise reduce current tax expense are added back, and under article 3.2.4 qualified refundable tax credits are treated as GloBE income. Together, these adjustments ensure that qualified refundable tax credits are characterized as above-the-line income when calculating jurisdictional ETRs for pillar 2.
[6] Alliance for Competitive Taxation, "OECD Pillar Two Model Rules on Minimum Taxation," Feb. 2, 2022.
[7] Treasury, "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals" (Mar. 2022).
[8] Treasury, "Remarks by Assistant Secretary for Tax Policy Lily Batchelder for the D.C. Bar Association" (May 5, 2022). *Also see* Natalie Olivo, "Certain U.S. Tax Credits Should Be OK in Pillar 2, Official Says," *Law360*, May 5, 2022.

tax incentives that are also non-refundable but would not benefit from equity treatment, such as the R&D credit. "We are working on ways to address that in the most efficient way possible," he said.[9]

It appears, therefore, that Treasury is expecting the *structure* of tax equity investments to spare U.S. taxpayers from the adverse pillar 2 consequences of earning non-refundable U.S. tax credits. We examine this technical argument below by reference to the OECD's pillar 2 model rules, but first it's necessary to understand how tax equity investments are typically accounted for. Most U.S. taxpayers will prepare U.S. generally accepted accounting principles accounts, which would be relevant for pillar 2 purposes, but international financial reporting standards could also be relevant to some non-U.S.-parented groups.[10]

Accounting under GAAP and IFRS

An investment in a joint venture partnership or LLC can in principle be accounted for in several ways under U.S. GAAP and IFRS. These range from a detailed level of disclosure in the case of full consolidation to light disclosure in the case of a cost-based or similar approach to measuring the investment, and there is an intermediate position with the "equity method." The level of disclosure for the investor turns on various tests looking at the investor's relationship with the joint venture, but the investor's level of *control* is a key factor. Put simply, with more control, an investor must give more detailed disclosure.

Assessing if consolidation is required is complicated under U.S. GAAP because there are different consolidation threshold tests, depending on whether the entity is a "variable interest entity" or a "voting interest entity."[11] Tax equity investments may fall into the variable interest entity category, which can apply when investors lack the power to direct the activities of a legal entity that most significantly affect the entity's economic performance. In contrast, under IFRS the requirement for consolidation is assessed by a single "control" test.[12] Whilst those consolidation thresholds are complex and depend on a close analysis of a given structure, a tax equity investor would not generally expect to have the level of control to require consolidation of a project into its group's accounts.

Short of consolidation, there are various approaches that a tax equity investor might use to measure its investment in a limited partnership or LLC. When an investor's control rights rise to the level of "significant influence,"[13] or alternatively "joint control"[14] under IFRS, the investor likely will be required to apply the equity method, in which its investment in the entity is adjusted by reference to its share of changes in the entity's underlying net assets.

Tax equity investments may have control rights that fall short of both consolidation and equity method accounting requirements. In that case, a "cost" method or similar is likely to apply. U.S. GAAP includes a specific "proportional amortization method" for "qualified affordable housing project investments," whereby the investor amortizes the initial cost of the investment in proportion to the tax credits allocated to the investor.[15]

It suffices for our purposes to summarise that tax equity investments will not typically be consolidated by investors. They may apply the equity method to measure their investment, but that is not necessarily the case; a cost or similar method may apply, especially when the investor has a low degree of influence.

Joint ventures under Pillar 2

A. Consolidated joint ventures

If an investor consolidated a project in which it had made a tax equity investment, the results of that project – including the non-refundable tax credits earned – would straightforwardly be included in that investor's jurisdictional ETR for the United States.[16] In that case, affected groups could risk exposure to a pillar 2 top-up tax regarding their U.S. operations if the tax credit pushes the U.S. ETR below 15 per cent. However, as noted

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[9] Stephanie Soong Johnston, "U.S. Working With OECD on Pillar 2 Clarifications on Tax Credits," Tax Notes Federal, May 9, 2022, p. 939; Michael Plowgian, counselor to Treasury Office of Tax Policy, speaking May 5, 2022.
[10] The OECD's pillar 2 model rules operate by reference to the consolidated accounting standards of the group's parent entity; OECD model rules article 3.1.2.
[11] Accounting Standards Update 2015-02, "Consolidation (Topic 810)" (Feb. 2015).
[12] IFRS 10, "Consolidated Financial Statements," para. 2.
[13] Accounting Standards Codification [ASC] 323-30-25-1.
[14] International accounting standard 28, "Investments in Associates and Joint Ventures," para. 2.
[15] ASC 323-740-35.
[16] See the OECD pillar 2 model rules definition of constituent entity in article 1.3.1 and the definition of group in article 1.2.2. Note that a deemed consolidated analysis will also apply under article 1.2.2(b) if an entity is "excluded from the Consolidated Financial Statements of the Ultimate Parent Entity solely on size or materiality grounds, or on the grounds that the Entity is held for sale."

above, this would not be a typical way to account for a tax equity investment; it is more likely to fall short of consolidation.

B. Ownership of at least 50 per cent

If the project is not consolidated, there is an express requirement that some equity-method-accounted joint ventures be included in a multinational's pillar 2 calculations. Those are defined as "joint ventures," and they occur when there is "an Entity whose financial results are reported under the equity method in the Consolidated Financial Statements of the Ultimate Parent Entity provided that the Ultimate Parent Entity holds directly or indirectly at least 50 per cent of its Ownership Interests."

In that situation, article 6.4.1 of the model rules applies the GloBE rules to the joint venture and its "JV subsidiaries," but on a modified basis. Top-up tax is calculated for these entities "as if they were Constituent Entities of a separate MNE Group and as if the Joint Venture was the Ultimate Parent Entity of that Group," with the multinational accounting for any top-up tax on its "allocable share." The key difference here is that the multinational cannot blend the results of the project with its own U.S. operations when calculating the ETR and any top-up tax.

There is a question whether, when calculating any top-up tax owed in relation to a joint venture, the multinational should take into account any tax saving from tax credits allocated to it directly (that is, when the saving is enjoyed by U.S. taxpayers in the multinational's *consolidated* group because of fiscal transparency of the joint venture entities). It is not completely clear how article 6.4.1(a) (which instructs you to apply articles 3 to 7 and 8.2 to the joint venture) should be applied when the joint venture is fiscally transparent. It may be that a top-up tax can still be visited on a multinational in an equity-method-accounted joint venture, but this concern would apply only if a tax equity investor held "at least 50 per cent" of the ownership interests in the joint venture.

C. Ownership of less than 50 per cent

If a joint venture is not consolidated, such that a multinational's investment is accounted for under the equity method or a cost or similar method, and (if an equity method applies) fewer than 50 per cent of the ownership interests are held, then there is no express rule that would bring the results of the joint venture within the scope of the multinational's pillar 2 calculations.

The principle that GloBE income and covered tax are allocated from a tax-transparent entity to its investors (article 3.5.1(b) and article 4.3.2(b)) applies only to "constituent entities" – that is, within the consolidated group. This rule does not pull into the scope of pillar 2 any income or tax that relates to nonconsolidated entities.

On the contrary, if the shares or partnership interests in the entity have been held for more than a year (so as not to be a "short-term portfolio shareholding"), the dividends or other distributions received or accrued from the entity will be "excluded dividends." Similarly, any fair value changes or gain or loss on disposition of ownership interests will be "excluded equity gain or loss" if either the equity method of accounting applies or the ownership interest is not a "portfolio shareholding." A portfolio shareholding is one in which ownership interests in an entity that are held by the MNE group "carry rights to less than 10 per cent of the profits, capital, reserves, or voting rights of that Entity at the date of the distribution or disposition." Excluded dividends and excluded equity gain or loss are excluded from calculating GloBE income.

When an item of income is excluded from GloBE income, the corresponding tax is excluded. In the terms of article 4.1.3(a) of the model rules, covered taxes are reduced by "the amount of current tax expense with respect to income excluded from the computation of GloBE income or loss under chapter 3." We think that, applying this principle, it would make sense for tax credits from a tax equity investment that gives rise to excluded equity gain or loss and excluded dividends (if there are any dividends or partnership distributions) to be disregarded in calculating the ETR of the investor.

This interpretation is in our view consistent with the general principle that can be seen in the OECD's model rules that earnings are allocated and ETRs are measured for the entities that generate the earnings. This is achieved by reallocating the tax consequences from other entities on which those tax consequences fall as a matter of law. For instance, controlled foreign corporation taxes and taxes on distributions received are reallocated from parent to subsidiary under the assignment rules in article 4.3.2.

Conclusions

Treasury may be correct in its assessment that common structures used for investments in renewable energy and low-income housing may offer protection to investors against pillar 2.

If a joint venture investment is sufficiently small in percentage terms that it is not consolidated, does not meet the 50-per cent-ownership-interests threshold, and yet the investment is of a sufficient percentage that it exceeds a “portfolio shareholding,” then it seems reasonable that the tax consequences of it should not affect the investor for pillar 2 purposes. For those equity method joint ventures in which the 50-per cent-ownership-interests threshold is met, it’s unclear how tax credits enjoyed by investors should be brought into account for pillar 2 – there is the possibility of some top-up tax to pay by reference to the joint venture in any event. Tax credit investments that are consolidated (as may be the case when the investment is not structured through a joint venture) would remain susceptible to pillar 2 offsetting the tax credit benefit.

The version of the Build Back Better Act that passed in the House of Representatives on November 19, 2021, included provisions to allow companies to elect to receive some clean energy tax credits as direct payments of equal value instead of being limited to an offset against the amount of income taxes actually due. Direct payment of those tax credits could allow them to be treated as qualified refundable tax credits, improving their treatment under pillar 2. However, it remains to be seen whether the legislation will pass into law and whether similar solutions can be found for other U.S. tax credits.

In any case, it does appear that common structures of tax equity investment may offer protection against adverse consequences under pillar 2. Treasury is alive to this issue, and further clarifications and measures might be forthcoming, including around those tax credits (such as R&D credits) for investments that are not usually structured in the same way. Treasury Secretary Janet L. Yellen recently commented that “many of our credits will count [under pillar 2]” and committed to “work with Congress to make sure that the benefits that Congress intended – the business credits – are structured so that they will be available.”[17]

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[17] Yellen, speaking at the U.S. Senate committee hearing, “The President’s Fiscal Year 2023 Budget” (June 7, 2022)ASC 323-740-35.