

Summary of Staff Discussion Draft: Energy Tax Reform

**Chairman Max Baucus
U.S. Senate Committee on Finance**

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Overview

As part of his work toward tax reform, Chairman Max Baucus is releasing a staff discussion draft today on energy tax reform. The Chairman and his staff are grateful to the Joint Committee on Taxation and Senate Legislative Counsel for their assistance with this draft.

The income tax has included energy-related incentives almost since its inception. Historically, the bulk of these incentives went to traditional fossil fuels, but since the 1970s an increasing share of tax preferences has gone to renewable energy. Tax incentives for the domestic production of clean energy, whether from fossil fuels or renewables, serve important policy objectives, including helping to prevent damage to our health, climate, and economy from air pollution and greenhouse gas emissions. By promoting the expansion and diversification of domestic energy production, they can also reduce our vulnerability to price shocks for specific energy sources and enhance national security.

Despite the importance of these objectives, our current collection of energy-related tax preferences is far less effective than it could be. And it has grown into a confusing and costly maze over time. Today, there are 42 different energy tax incentives, including more than a dozen preferences for fossil fuels, ten different incentives for renewable fuels and alternative vehicles, and six different credits for clean electricity. Of the 42 different energy incentives, 25 are temporary and expire every year or two. The credits for clean electricity alone have been adjusted 14 times since 1978 – an average of every two and a half years. Our current energy tax incentives also result in significant revenue loss. If we to continue to extend current incentives, they will cost nearly \$150 billion over ten years.

Furthermore, our existing energy incentives provide different levels of subsidies for different technologies, picking winners and losers with no discernable policy rationale. For example, some clean energy production, such as generating electricity by capturing excess heat at manufacturing facilities, is ineligible for the production tax credit because it is not expressly listed in the code. Other types of energy production generating significant air pollution receive sizable tax subsidies.

We need more rational, targeted, and simple energy incentives to increase our energy security and ensure a clean and healthful environment for future generations.

Goals of the Staff Discussion Draft

Over the past three years, the Finance Committee has held six hearings related to energy tax reform. The Committee has also issued a paper on tax reform options under consideration in this area.

Drawing upon these efforts, this staff discussion draft proposes a streamlined, predictable, and technology-neutral set of energy tax incentives that focuses on promoting domestic energy production and reducing pollution. The proposed incentives are flexible enough to accommodate advances among fuels and technologies of any type – fossil or renewable. Specifically, the staff discussion draft promotes the following objectives:

- Eliminates current law incentives that are inefficient or no longer necessary, and replaces the remaining provisions with a small number of incentives that are simpler and more transparent.
- Focuses energy tax policy on stimulating domestic, clean production of electricity and transportation fuels, which account for 68 percent of energy consumed in the United States, in order to promote energy security and a clean environment.
- Ensures that all energy tax incentives are technology-neutral, and provides an equal credit to all resources or technologies based on how clean they are.
- Provides businesses and investors with more certainty by making incentives long enough to be effective, but phases incentives out once clearly defined goals have been met.

Summary of the Staff Discussion Draft

The staff discussion draft advances these goals through the reforms described below. While the Chairman believes tax reform as a whole should raise significant revenue for deficit reduction, the package of business reforms in this and other staff discussion drafts is intended to be revenue-neutral in the long-term (i.e., in a steady state), with corporate base broadeners paying for a significant reduction in the corporate tax rate. These proposals are meant to be considered as a package and not as stand-alone proposals.

Clean Electricity

As described further below, the staff discussion draft replaces the existing patchwork of incentives for clean electricity with a new tax credit that is technology-neutral and performance-based. The cleanliness of the generating technology determines the size of the credit. For any type of electricity generation, a business can choose whether it wants to receive the credit as a production tax credit, which is claimed each year, or an investment tax credit, which is claimed when the facility begins to operate. The tax credit expires when the cleanliness of the U.S. electricity market increases significantly.

This proposal draws upon S. 401 (113th), the Incentivizing Offshore Wind Act, sponsored by Sens. Carper, Brown, Cardin, Collins, Coons, Cowan, Gillibrand, King, Lautenberg, Menendez, Mikulski, Reed, Schatz, Warren, and Whitehouse; S. 570 (113th), the Clean Energy Race to the Top Act, sponsored by Sen. Bennet; S. 2201 (112th), the American Energy and Jobs Promotion Act, sponsored by Sens. Grassley, Bennet, Brown, Franken, Harkin, Heller, Johnson, Merkley, Nelson, Mark Udall, and Wyden; and S. 3581 (112th), “A bill to... modify the credit for carbon dioxide sequestration,” sponsored by Sens. Conrad, Enzi, and Rockefeller.

- **Clean electricity tax credit.**

- Any facility producing electricity that is about 25 percent cleaner than the average for all electricity production facilities will receive a tax credit. The cleaner the facility, the larger the credit.
 - Cleanliness is defined by a simple ratio of the greenhouse gas emissions of a facility, as determined by the Environmental Protection Agency (EPA), divided by its electricity production.
- Businesses can choose between claiming the credit as a production tax credit or an investment tax credit.
 - The maximum production tax credit for a zero emissions facility is \$0.023 per kilowatt of generation, indexed for inflation. The production tax credit can be claimed on a single facility for a maximum of 10 years and cannot be claimed for facilities that begin to operate before January 1, 2017 (though such facilities may be eligible for the extended, current law production tax credit, described below).
 - The maximum investment tax credit is 20 percent of the cost of the investment. Generally the investment tax credit cannot be claimed for facilities that begin to operate before January 1, 2017. However, after

2016, a 20 percent investment tax credit can be claimed for existing facilities that undertake a carbon capture and sequestration retrofit that captures at least 50 percent of carbon dioxide emissions.

- The credit phases out over four years once the greenhouse gas intensity of the U.S. electricity generation declines to the point that it is 25 percent cleaner than 2013.
- In order to qualify for the credit, the electricity must be produced in the United States.
- **Transition rules.** The following three expiring provisions are allowed to continue through 2016 to provide a transition period for technologies that rely on current law incentives:
 - Section 45 credit for renewable electricity production
 - Section 48 investment tax credit for electricity
 - Section 25D credit for residential renewable electricity investments
- **Consolidated tax incentives.** This staff discussion draft consolidates seven different tax incentives for electricity generation. In addition, the staff discussion draft on cost recovery and tax accounting, which was released on November 21, 2013, proposed repealing another electricity generation incentive: accelerated depreciation for solar, wind, and other energy property.

Clean Fuels

Like electricity, the staff discussion draft also replaces the current patchwork of incentives for clean fuels with a new tax credit for clean transportation fuel that is technology-neutral and performance-based. The cleanliness of the fuel determines the size of the credit. Businesses can claim the credit as either a production tax credit or investment tax credit. The tax credit phases out when the cleanliness of the U.S. transportation fuel market increases significantly.

This proposal draws upon S. 656 (113th), the Natural Gas Energy and Alternatives Rewards Act, sponsored by Sen. Casey; S. 1564 (112th), the Renewable Fuel Parity Act, sponsored by Sens. Tom Udall and Crapo; and S. 1277 (112th), the Biodiesel Tax Incentive Reform and Extension Act, sponsored by Sens. Cantwell, Blunt, Franken, Grassley, Harkin, Johnson, Klobuchar, Murray, Shaheen, and Thune.

- **Clean transportation fuel tax credit.** Any fuel that is about 25 percent cleaner than conventional gasoline will generally receive a credit. The cleaner and more energy efficient the fuel, the larger the credit.
 - Cleanliness is defined as how clean a given fuel production process is on a lifecycle emissions basis, as determined by the EPA.
 - In order to simplify the credit calculation and allow businesses to plan effectively, EPA has authority to group similar production processes together and is required to provide provisional credit amounts for new technologies within 12 months of application.
 - Energy efficiency is defined as the energy density of a fuel compared to conventional gasoline.
 - The credit per gallon of fuel is calculated by multiplying its cleanliness by its energy efficiency.
 - Businesses can choose between claiming the credit as a production tax credit or an investment tax credit.
 - The maximum production tax credit for a fuel with the same energy content as gasoline and with zero lifecycle emissions is \$1 per gallon. It can be claimed for a maximum of 10 years after a facility begins to operate. It cannot be claimed for fuel produced before December 31, 2016 (though such fuel may be eligible for the extended, current law production tax credit, described below).
 - The maximum investment tax credit is 20 percent of the cost of the investment. It is only available for facilities that begin to operate after December 31, 2016.
 - In order to qualify for the credit, the fuel must be produced and sold within the United States.
 - The credit phases out over four years once the greenhouse gas intensity of all transportation fuels has declined to a level that is 25 percent cleaner than conventional gasoline.
- **Transition rules.** The following three provisions that expire at the end of 2013 under current law are extended through 2016 to provide a transition period for technologies that rely on current law incentives:

- Section 40, 40A, and 6426 credits for transportation-grade, renewable, and alternative fuels

Consolidated tax incentives. This staff discussion draft consolidates four different tax incentives for transportation fuels. In addition, the staff discussion draft on cost recovery and tax accounting, which was released on November 21, 2013, proposed repealing two additional fuel production tax incentives: accelerated depreciation for cellulosic biofuel refineries and for refinery property for certain qualified fuels.

Repeal of Other Energy Tax Provisions

The staff discussion draft on cost recovery and tax accounting proposed repealing 11 current energy-related tax incentives that are not targeted on domestic production of electricity or fuels. In addition, this staff discussion draft proposes repealing or allowing to expire the following 11 provisions:

- Section 25C credit for residential energy efficiency
- Section 30B credits for fuel cell motor vehicles
- Section 30D credits for electric plug-in vehicles
- Section 43 credit for enhanced oil recovery costs
- Section 45I marginal well production credit
- Section 45N mine rescue training credit
- Section 45Q carbon dioxide sequestration credit
- Section 45L credit for construction of energy-efficient new homes
- Section 45M credit for energy efficient appliances
- Section 48C credit for investment in advanced energy property
- Treatment of gain resulting from Federal Energy Regulatory Commission restructuring

Unaddressed Issues and Request for Comments

Comments are requested on all aspects of the staff discussion draft as well as other areas of energy tax reform. Comments on the additional issues listed below are of particular interest. All comments should be submitted to tax_reform@finance.senate.gov. While comments will be accepted at any time, the staff requests comments by January 31, 2014 in order to give them full consideration.

- This staff discussion draft focuses on developing two simple, technology-neutral tax incentives for domestic production of clean electricity and clean fuels. The draft does not include tax incentives for other parts of the U.S. energy economy, such as energy

efficiency, clean vehicles, transmission, combined heat and power, and storage. Staff made this choice in order to target tax incentives on areas that appear to have the largest bang-for-the-buck in reducing air pollution and enhancing energy security, given concerns about overlapping regulations and spending programs, compliance costs, and the potential for fraud or abuse. For example, the tax code currently includes investment tax credits for infrastructure to deliver clean fuels from the refinery to vehicles. While this infrastructure is a critical part of the fuel supply chain, staff believe that it is most important to build the supply of clean fuels first. Without this supply, the infrastructure to deliver clean fuels will not exist. As another example, staff is concerned about the abuse of energy efficiency tax credits for residential home improvements that was highlighted by a September 2011 report by the Treasury Inspector General for Tax Administration citing thousands of fraudulent tax returns claiming the credit. However, staff is interested in comments on whether some or all of the revenue devoted to the credits proposed in this draft should be directed at these other sectors of the energy economy instead. Comments are also requested on whether and how tax incentives for these sectors could be implemented on a technology-neutral basis.

- The staff discussion draft proposes two tax credits for clean energy production. An alternative would be to discourage energy production that is not clean. Comments are requested on the overall merits of approaching energy policy through a subsidy for clean technologies versus a tax or fee on heavy polluting technologies or air pollution. Additional comments are requested on how to design such a tax or fee so that it would not harm trade-exposed and energy-intensive industries, and would not disproportionately harm low-income households.
- The proposed tax credits for production of clean electricity and transportation fuel phase out once the electricity generation and transportation fuel markets reach certain benchmarks of cleanliness. Comments are requested on other ways to appropriately phase out the policies described in this draft.
- The staff discussion draft generally limits the proposed production and investment tax credits to facilities that begin to operate after 2016. Comments are requested on whether it is appropriate to make the credits available to facilities placed in service before 2016 that convert to clean generating facilities and, if so, how such a policy should be designed.
- The investment tax credits in the staff discussion draft are recaptured if a facility's actual emissions are significantly less clean than when the facility was originally placed in

service. Comments are requested about whether the proposed recapture provisions are appropriate.

- In the staff discussion draft, the amount of credits provided for various clean fuel and electricity technologies is based on their cleanliness as determined by the EPA. Comments are requested on how to most effectively design a pre-certification process for new technologies.
- The staff discussion draft proposes an investment tax credit for retrofitting existing facilities with carbon capture technologies that capture at least 50 percent of their previous carbon dioxide emissions. Comments are requested on whether 50 percent is an appropriate threshold, whether the credit should be performance-based, and whether this credit will effectively promote adoption of carbon sequestration technologies.