

The “Right” way to Model the Timing of Recognition of ITC

Tax advisors working on investment tax credit (ITC) transactions are often asked what is the “right” way to model the timing of the recognition of the ITC benefit in an after-tax cash flow model. There is not one answer to this question; further, some public companies in their after-tax cash flow models allow their financial statement accounting policy regarding recognition of the ITC to influence their treatment of the ITC benefit in after-tax cash flow models.

There appear to be two plausible approaches with respect to the timing of ITC benefit in an after-tax cash flow model. First, the taxpayer could model the ITC benefit as arising from a reduction in the estimated taxes that would otherwise be due on the estimated tax payment date that follows the placed in service date of the project that qualified for the ITC. The rationale for this approach is that the ITC will reduce the estimated tax payments due for that period, so the benefit arises on the day such estimated taxes are due.¹

There is a second approach that could be defensible for certain very large taxpayers that have significant tax benefits from a variety of transactions. Such a taxpayer could adopt the view that a single investment tax credit transaction would not have a material impact on its estimated taxes for any particular payment period. Therefore, such a taxpayer would model the benefit as arising on April 15th following the year in which the project is placed in service. Such taxpayers often request extensions and file their tax returns later in the year than April 15th; however, if, at the time the taxpayer requests the extension, it had not paid all of its tax liability for the applicable tax year then the taxpayer is subject to an IRS interest charge. Therefore, the economic benefit arises on April 15th, even if the actual tax return is filed later.

Nonetheless, some tax equity investors reject both of these approaches and prefer to spread the recognition of the ITC benefit across fiscal quarters. This approach appears to be a blending of after-tax cash flow projections with a financial accounting concept: they allocate the ITC benefit across the quarters remaining in the year the ITC eligible project is to be placed in service. This approach may be based on the assumption that once a transaction is in place, the estimated taxes to be paid during the remainder of the tax year in which the credit will be claimed will be reduced by the amount of the credit.² This modeling convention also appears to be an effort to have the modeled projected benefit from the ITC parallel what is required for financial statement reporting by ASC 740-20-45 of U.S. GAAP.³ ASC 740-

¹ Estimated tax payment dates are:

<u>Payment Period</u>	<u>Estimated Taxes Due Date</u>
January 1 to March 31	April 15
April 1 to May 31	June 15
June 1 to August 31	September 15
September 1 to December 31	January 15

² If a transaction is being modeled for investment consideration prior to an estimated tax payment date but the project will be placed in service after the estimated tax payment date (e.g., the transaction is being modeled during February 2017 and the project is scheduled to be placed in service in December 2017, particularly confident investors could spread the ITC benefit across all four estimated tax payment dates (i.e., April 15, June 15, September 16 and January 15) on the theory that the ITC from the December in-service date will effectively reduce what has to be paid in estimated taxes on the April, June and September dates that pre-date the in-service date. However, this approach means that if the in-service date slips until after December, then it is likely to mean insufficient estimated taxes were paid to the IRS for prior periods, which would result in the imposition of an interest charge by the IRS.

³ A closely related financial accounting issue is whether the tax equity investor uses the “flow through” or “deferral” approach to determine in which fiscal year it recognizes the ITC benefit on its financial statements. This question is governed by GAAP and is not reflected in after-tax cash flow model.

Flow through means the ITC is recognized as a reduction of income tax expense that must be provided on the financial statements for the fiscal year the project is placed in service. The arguably less favorable treatment is

20-45, provides that a public company's effective tax rate (ETR) should not vary significantly from quarter to quarter within a fiscal year (i.e., the ETR should not be *lumpy*).

The ITC, unlike accelerated depreciation, is a tax benefit that reduces the ETR because it reduces the amount of taxes permanently due. Therefore, to avoid having a 10% ETR in one quarter and a 40% ETR in another quarter, the ITC benefit for a particular year is typically prorated for financial statement purposes across the remaining quarters in the fiscal year in order to generally conform to ASC 740-20-45. Tax equity investors in this camp opt to use the same convention to model the ITC benefit in after-tax cash flow models.

Such a convention means that the later in the year the project is to be placed in service the greater the time value benefit of the ITC benefit will be in the model, because the ITC from a project cannot be spread across quarters of a fiscal year for which the books are already closed. The management of some companies in this camp found that this convention motivated their deal teams to favor fourth quarter deals. A disproportionate number of fourth quarter deals can strain the staffing capacity of a company, and if the fourth quarter deals are unable to be closed there is no remaining time to book deal volume for the year. Therefore, the management of some tax equity investors adopted a modeling convention that for projects placed in service in the fourth quarter the ITC benefit is divided between the fourth quarter of the current year and the first quarter of the following year in order to dilute the incentive for the sales force to close as many deals in the fourth quarter as possible. It is important to emphasize that dividing the benefit between the fourth quarter of the current year and the first quarter of the next year is merely a modeling convention and tracks neither the actual financial statement nor income tax reporting.

Another rationale for some tax equity investors dividing the ITC benefit across certain quarters of the year is that their corporate parent uses such a convention to compensate its subsidiaries for tax benefits realized by the subsidiary that reduce the consolidated group's federal income tax liability. Under such an arrangement, the corporate parent plays the role of tax collector for its subsidiaries; the rules as to when a subsidiary receives the benefit or detriment are governed by the tax sharing agreement amongst the parent and its subsidiaries. If the performance of the subsidiary and its employees is measured, for purposes of compensating such employees, based on the rules of the tax sharing agreement, then the employees of that subsidiary are incentivized to have their cash flow models track such rules.

In companies where the compensation of employees that originate ITC transactions is not measured based on the financial consequences of the actual timing of estimated tax payments (or comparable adjustments with the corporate parent), attempting to mimic the actual precise timing of the estimated tax payments can place the deal teams at odds with the accounting department that manages the actual payment of estimated taxes and the allocation of the effect of such payments back to the individual business units. How the tax payments are modeled for a financial transaction may be substantially different than how they are actually handled between the subsidiary and its parent.

deferral: recognition of the ITC straight-line over the number of years the project is being depreciated for financial statement purposes. The deferral method is described at ASC 740-10-25-46 as of U.S. GAAP as being considered the preferable method. However in the case of most investments eligible for ITC that are often subject to a contractual arrangement providing some assurance as to cash flow, the term of such contracts is often less than the useful life of the asset; therefore, the deferral deferring ITC recognition for financial statement reporting over an extremely long period does not appear to be consistent with the tenor of the financial arrangements of the underlying transaction. See, <http://www.money-zine.com/definitions/investing-dictionary/investment-tax-credit>. That is the economic "useful life" used for financial statement purposes (not the five year MACRS life used for income tax purposes); for a solar project that could be 35 years or more. Companies that claimed the ITC prior to the Tax Reform Act of 1986, when new equipment of all types was ITC eligible and more likely to have adopted the less favorable deferral approach.

The various conventions described above demonstrate how tax equity investors can be idiosyncratic. It often is a fruitless effort for a project developer to try to persuade an experienced tax equity investor to modify its approach to modeling the projected timing of the ITC benefit. However, if the transaction happens to be an investor's first ITC eligible investment, the developer may be able to gently guide it to the convention of modeling the projected ITC benefit on the estimated tax payment date that follows the date the project is projected to be placed in service. Further, for both tax equity investors and developers in transactions in which the sharing of economics "flips" after the tax equity investor achieves an after-tax internal rate of return on its investment,⁴ the critical principle is that the deal model's approach to the timing of the recognition of the ITC benefit ties to the provisions in the transaction documents that govern the calculation of the tax equity investor's after-tax internal rate of return (and accordingly when the flip will be determined to have occurred).

When developers model projects for investment planning purposes in anticipation of how the tax equity market will view the project, they need to ensure that even if the actual tax equity investor has one of the less favorable ITC modeling conventions that the economics of the transaction will still be acceptable. In other words, do not use too sharp a pencil when undertaking generic modeling of the ITC benefit for a project in the early stages of consideration.

⁴ See, e.g., Revenue Procedures 2007-65 and 2014-12.