Energy Related Tax Provisions in the President's 2012 Budget

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President Obama's recently released budget proposal contains energy-related tax provisions for the 2012 fiscal year.

On February 14, the Obama administration released its revenue proposal (Proposal) for the fiscal year 2012. The Proposal would repeal or expand several energy-related tax provisions, some of which were also proposed in the 2011 revenue proposal. To view our newsletter on the energy tax provisions in the 2011 proposal, see "Key Energy-Related Tax Provisions in the 2011 Budget Proposal."

The following is a summary of the energy-related tax provisions contained in the Proposal:

Extension of the Grant in Lieu of Investment Tax Credits Pursuant to Section 1603 of the Recovery Act

Section 1603 of the American Recovery and Reinvestment Act of 2009 (Recovery Act) provides for a cash grant in lieu of the investment tax credit equal to 30 percent of eligible renewable energy project costs. The grant is set to expire at the end of this year and currently applies to renewable energy projects placed in service in 2009, 2010 or 2011 or with respect to which construction has begun during such years. The Proposal would extend the grant program through 2012.

For additional information on this grant and its extension last year, see "Congress Passes Bill Extending Section 1603 Grant and Other Energy-Related Incentives."

Expansion of the Tax Credits for Investment in Eligible Property Used in a Qualified Advanced Energy Manufacturing Project

The Recovery Act provided a 30 percent tax credit for investments in eligible property used in a qualifying advanced energy project. A qualifying advanced energy project is a project that re-equips, expands or establishes a manufacturing facility for the production of property designed to produce energy from renewable resources; fuel cells, microturbines or an energy storage system for use with electric or hybrid-electric vehicles; electric grids to support the transmission, including storage, of intermittent sources of renewable energy; property designed to capture and sequester carbon dioxide emissions; property designed to refine or blend renewable fuels or to produce energy conservation technologies; electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles; and other advanced energy property designed to reduce greenhouse gas emissions.

This credit was previously capped at $2.3 billion, which, according to the U.S. Treasury's explanation of the Proposal, resulted in the funding of less than one-third of the technically acceptable applications that were received. Thus, the Proposal would authorize an additional $5 billion of these credits for advanced energy manufacturing projects. In addition, it would permit taxpayers to apply for the credit with respect to only part of their qualified investment in a project. Because a credit for only part of a qualified project would reduce the government's share of a project's costs, the Proposal provides that a taxpayer's application for a partial credit would be taken into account by the government in determining whether to allocate credits to the project. Applications for the credits would be made during the two-year period beginning on the date on which the additional authorization is enacted. To read more on the application process and criteria for this credit under the previously authorized $2.3 billion, see "Applications Now Accepted for Advanced Energy Tax Credits."

Replacement of Deduction for Energy-Efficient Commercial Buildings with Tax Credit

The Proposal would provide for a tax credit to replace the existing deduction for energy efficient commercial buildings under Section 179D of the Internal Revenue Code (Code). The tax credit would apply to qualified property that is designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation and hot water systems of a building by 20 percent or more in comparison to certain reference buildings. In contrast, the deduction generally applies to similar property designed to reduce the same costs by 50 percent.

This tax credit would be limited to $0.60 per square foot in the case of energy efficient commercial building property designed to reduce the total annual energy and power costs by at least 20 percent but less than 30 percent, to $0.90 per square foot for qualifying property designed to reduce the total annual energy and power costs by at least 30 percent but less than 50 percent, and to $1.80 per square foot for qualifying property designed to reduce the total annual energy and power costs by 50 percent or more. Special rules would apply to allow the credit to benefit a real estate investment trust (REIT) or its shareholders.

This tax credit would be available for property placed in service during the 2012 calendar year.

Extension and Expansion of the New Markets Tax Credit

Late last year, Congress extended the new markets tax credit for investments in low-income communities through 2011 and allocated $3.5 billion for each of 2010 and 2011 years. (For more information, see "Congress Passes Bill Extending Section 1603 Grant and Other Energy-Related Incentives." The new markets tax credit provides a credit for qualified equity investments made to acquire stock in a corporation or a capital interest in a partnership, that is a qualified community development entity (CDE) that is held for a period of seven years. The credit is a credit taken

over seven years and is generally equal to 5 percent of the amount of the taxpayer's investment in the CDE for the first three years and 6 percent of such investment for the last four years. Currently, the new markets tax credit can be used to offset federal income tax liability but cannot be used to offset alternative minimum tax (AMT) liability.

The Proposal would extend the new markets tax credit for one year through 2012 with an allocation amount of $5 billion. The Proposal would also permit new market tax credit amounts resulting from qualified investments made after December 31, 2010 to offset a taxpayer's AMT liability.

Taxation of Carried Interests

The Proposal includes as a revenue-raising provision the taxation of carried interests, a legislative change which has been proposed several times over the past year or so. The provision would tax a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, as ordinary income. In addition, the provision would require the recipient partner to pay self-employment taxes on such income, and gain recognized on the sale of an ISPI would generally be taxed as ordinary income, rather than capital gain. The Treasury's explanation of the Proposal defines an ISPI as a carried interest in an "investment partnership" that is held by a person who provides services to the partnership. A partnership is an "investment partnership" if the majority of its assets are investment-type assets, which the Treasury describes as certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets, but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property held for the production of income.

Additional nuances to the taxation of carried interests provision exist in the Proposal, including an anti-abuse rule targeting convertible or contingent debt, options or other derivative instruments with respect to investment partnerships. The provision would be effective for taxable years beginning after December 31, 2011.

Expansion of the Research and Experimentation Credit

The Proposal would expand and make permanent the credit for research and experimentation, which was set to expire at the end of 2011. The research and experimentation credit equals 20 percent of eligible costs for qualified research and experimentation expenditures above a base amount. The base amount is generally computed by looking at the ratio of the taxpayer's research expenditures to its gross receipts for past periods. The Proposal would also enhance the elective simplified research credit under this provision from a 14 percent credit to a 17 percent credit.

Require Ordinary Gain or Loss Treatment for Section 1256 Contracts Entered into by Commodities "Dealer"

The Proposal has recycled an item that was included in last year's budget proposals which, if adopted, would require "dealers" in commodities and commodities derivatives to treat the income from their day-to-day dealer activities in Code Section 1256 contracts as resulting in ordinary gain or loss.

As a general matter, Code Section 1256 contract gains or losses are capital unless altered by another rule. Other rules that currently convert Code Section 1256 contract gains and losses to ordinary are the hedging rules of Code Section 1221 and the dealer and trader mark to market elections under Code Section 475.

This proposal would essentially override the general starting point of capital gain or loss from Code Section 1256 contracts for eligible dealers, without having to rely on the hedging rules or Code Section 475 mark to market elections. If adopted, the proposal would be effective for taxable years beginning after the date of enactment.

Elimination of Fossil Fuel Preferences

The Proposal's expenditures are to be funded in part by the elimination of fossil fuel preferences. The Proposal would eliminate most fossil fuel tax preferences, including:

- Repealing the enhanced oil recovery credit for taxable years beginning after December 31, 2011.
- Repealing the credit for oil and gas produced from marginal wells for taxable years beginning after December 31, 2011.
- Repealing expensing for intangible drilling costs and 60-month amortization of capitalized intangible drilling costs for costs paid or incurred after December 31, 2011.
- Repealing the deduction for tertiary injectants for amounts paid or incurred after December 31, 2011.
- Repealing the exception to the passive loss limitation for working interests in oil and natural gas for taxable years beginning after December 31, 2011.
- Repealing percentage depletion for oil and natural gas wells, as well as for coal and other hard mineral fossil fuels, for taxable years beginning after December 31, 2011.
- Repealing the domestic manufacturing deduction for oil and natural gas companies for taxable years beginning after December 31, 2011. A similar proposal would apply to coal and hard mineral fossil fuel production.
- Increase the geological and geophysical amortization period from two years to seven years for independent oil and gas producers for amounts paid or incurred after December 31, 2011.
- Repealing expensing, 60 month and 10 month amortization for exploration and development costs relating to coal and other hard-mineral fossil fuels for costs paid or incurred after December 31, 2011.

- Repealing capital gains treatment of coal and lignite royalties in favor of taxing those royalties as ordinary income, effective for amounts realized in taxable years beginning after December 31, 2011.

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