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Congress Wishes the Renewable Energy Industry A Merry Christmas, But More Remains To Be Done

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On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Job Creation Act"), extending for one year the cash grant program for renewable energy projects, which was initially enacted as part of the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"). In addition, the Job Creation Act permits businesses to fully expense the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012. These provisions are of vital importance to the renewable energy industry.

Background

The renewable energy market relies on tax benefits to help generate competitive returns. The primary tax benefits are accelerated tax depreciation, the production tax credit ("PTC") and the investment tax credit ("ITC"). PTC is principally used for wind, biomass, geothermal, municipal solid waste (including landfill gas), qualified hydropower, and marine and hydrokinetic energy facilities. ITC is principally used for solar property, certain geothermal property, qualified fuel cell property, qualified microturbine property, combined heat and power system property, small wind energy property, and geothermal heat pump property.

The PTC is claimed over a 10-year period and is based on the number of qualified kilowatt hours of electricity produced and sold during the tax year. The amount of the credit increases each year for inflation and currently equals 2.2 cents per kilowatt hour (1.1 cents per kilowatt hour for most biomass facilities, small irrigation, municipal solid waste, qualified hydropower, and marine and hydrokinetic). The ITC for energy property equals 30 percent of the eligible cost of qualified energy property placed in service during the year (10 percent for geothermal heat pump property, microturbine property, combined heat and power property, and qualified geothermal property).

The Recovery Act allowed taxpayers to elect to receive a cash grant in lieu of ITC or PTC for specified energy property that is placed in service during 2009 or 2010, or by a later credit termination date if the property is not placed in service during 2009 or 2010 but construction has begun during 2009 or 2010. In

general, the grant amount is 30 percent of the basis of the qualified property. For qualified microturbine, combined heat and power system, and geothermal heat pump property, the amount is 10 percent of the basis of the property.

The cash grant is not includible in gross income, but the basis of the energy property is reduced by 50 percent of the amount of the grant. The grant is not available to disqualified entities such as governmental entities, tax-exempt organizations, or partnerships or limited liability companies that have a disqualified entity as a member. A taxpayer that receives a cash grant may be required to recapture all or a portion of the grant if the taxpayer disposes of the specified energy property to a disqualified entity within five years of the date that the property is placed in service.

Extension of Cash Grant Program

The Job Creation Act extends the cash grant program for one year (through 2011). Under the new rules, cash grants are available for eligible property placed in service in calendar years 2009, 2010, or 2011, or by a later credit termination date if construction of the property begins by the end of 2011. The credit termination date is December 31, 2012 (in the case of wind facility property), December 31, 2013 (in the case of biomass, geothermal, municipal solid waste, qualified hydropower, and marine and hydrokinetic energy facilities), and December 31, 2016 (in the case of solar property, certain geothermal property, qualified fuel cell property, qualified microturbine property, combined heat and power system property, small wind energy property, and geothermal heat pump property).

The question of what a taxpayer needs to do in order to be treated as having begun construction under the cash grant rules has been the subject of much discussion. In general, the taxpayer can satisfy the test either by satisfying a physical construction test or by satisfying a 5 percent safe harbor.

Under the physical construction test, the taxpayer must begin physical work on the specified energy property before the end of 2011, and such work must be part of a continuous program of construction. Under the safe harbor, the taxpayer must pay or incur 5 percent of the total cost of the specified energy property before the end of 2011. The taxpayer can count work performed and costs incurred by a third party pursuant to a binding written contract for purposes of satisfying these tests. The Treasury Department has issued extensive guidance that applies these rules in a variety of circumstances.

To be placed in service, property must be fully installed and capable of being used by the taxpayer for its intended purpose. Typically this means the taxpayer has to have legal title and control, all licenses and permits must have been received, all preoperational tests must be complete, and the property must be fully installed on site. The Internal Revenue Service has taken the position that the property must be in daily operation, though most tax lawyers do not think daily operation is required.

Expensing Equipment Cost

Most renewable energy property is depreciable over five years under an accelerated depreciation method. Prior to the Job Creation Act, an additional first-year depreciation deduction was allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2011 for certain longer-lived property). The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.

The Job Creation Act extends and expands the additional first-year depreciation to equal 100 percent of the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived property), and provides for a 50 percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011 and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived property).

Passive Loss Rules Remain an Obstacle

The passive loss rules continue to prevent wealthy individuals from monetizing depreciation benefits, which effectively limits the ability of such taxpayers to invest in renewable energy projects in an economically efficient manner. Consequently, investment in renewable energy is not as robust as it otherwise would be.

Specifically, under the passive loss rules, individuals and certain other taxpayers are not able to utilize losses from so-called *passive activities* to offset income attributable to wages, income from portfolio investments or income from active businesses. In general, a passive activity is an activity involving the conduct of a trade or business in which the taxpayer does not materially participate, such as an investment in a typical renewable energy project.

Because most renewable energy projects generate tax losses in the early years due to accelerated depreciation, individual investors are limited in their ability to fully utilize depreciation benefits-they can use the depreciation to offset gross income from the renewable energy project (or from other passive activities in which they may have invested), but any additional tax benefits are deferred until the individual has other passive income, or fully disposes of his or her interest in the renewable energy project.

Certain states, such as New Jersey, have robust markets for renewable energy certificates ("RECs"). In general, RECs are issued by the state to renewable energy suppliers and are sold by such suppliers to

utilities to enable the utilities to satisfy state-imposed renewable portfolio standards. Depending on trading prices, the income generated by REC sales can be sufficient to permit individuals who invest in renewable projects to fully utilize their tax benefits, and renewable energy investment by individuals in such states can often generate substantial after-tax returns.

In other states, however, investment in renewable energy projects tends to be dominated by banks, insurance companies, and large financial institutions because such entities are generally exempt from the passive loss rules. Exempting renewable energy projects from the passive loss rules would go a long way toward improving the economic environment for investment in such projects, because such an exemption would permit wealthy individuals to pool their resources through partnerships and other investment vehicles to provide financing in an economically viable manner, and thereby provide the capital required to expand the renewable energy market.

If you have any questions regarding the new legislation, or the tax treatment of renewable energy investments generally, please contact one of the authors of this Alert or the Reed Smith attorney with whom you regularly work.

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