Renewable Energy Alert

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New Section 48C provides a 30% tax credit for manufacturing renewable energy equipment

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This *Alert* considers one of the truly new provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) with extraordinary potential -- new Section 48C of the Tax Code, which provides $2.3 billion of potential tax credits for "qualifying advanced energy projects", i.e., manufacturing facilities related to renewables. On August 13, in Notice 2009-72, Treasury provided guidance and some of the forms relevant to the new credits.

Unlike many of the credits that we've discussed in other *Renewable Energy Alerts*, the 48C credit is distinguished in several ways:

- It's competitive. An applicant will have to submit a successful application to qualify for the credit. Treasury expects about 1000 applications.
- It has a very accelerated application process. As we discuss below, some parts of the application have a very short application period. In particular, the preliminary description of a project must be submitted to the Department of Energy by September 16, 2009.
- It's a credit for investing in the manufacture of renewable energy equipment, not for the generation of renewable energy. The credit applies to new manufacturing facilities, as well as refurbishing or expanding existing facilities.
- It's huge. The new credit is a hefty 30% of the equipment's cost, far larger than the somewhat similar 10% investment tax credit of the 1980s.

In this *Alert*, we'll discuss the rules that apply to Section 48C and how we expect the credit to be administered. As you read this, remember one important consideration – even once a project is awarded credits, this is only the *beginning of the process*. The project still has to be developed and placed in service substantially as it was described to Treasury and the Department of Energy; the mere selection of a project does not assure that credits will actually be available to reduce tax liability.

First, the basic rules:

1. **What is a tax credit?** The balance of this *Alert* is about Section 48C. If you know how credits work, then skip ahead to item 2, but, for those of you who would like an introduction, you can start here.

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A tax credit is a "dollar for dollar" reduction in tax liability. Suppose you earn $10 million and owe about $3.5 million in taxes (at a 35% tax rate). A $1m tax credit would reduce your tax liability from $3.5 million to $2.5 million. This is better than a tax deduction, which is typically worth about 35 cents on the dollar (again, presuming a 35% tax rate). Of course, to use a tax credit, you have to be paying taxes, and the alternative minimum tax can limit the ability to use certain tax credits, including the Section 48C credit.. Because many developer-owners of projects that are eligible for credits have relatively small liabilities for federal income tax, instead of claiming the credit themselves, they may partner with high-income taxpayers, transferring the tax credits to those partners in exchange for cash payments.

Alternatively, the user-developer may arrange to transfer the property to a high-income taxpayer which will then lease it back to the user-developer at a lower rent than would otherwise apply, because the owner-lessor's costs have been reduced by the amount of the tax credit. For example, if the property costs $10 million, but it qualifies for a 30% tax credit, then the owner-lessor's *effective cost* is only $7 million. With lower costs, the investor-owner can charge the user-developer less rent and still cover its other costs.

Tax credits are subject to an array of rules, some of which apply even if the user of the credit property keeps it for itself and doesn't involve an "investor". Other rules apply if an investor is brought in to pay for the credit. It is important to remember that the tax rules almost never allow a credit to be "sold". Instead, the investor has to participate in a partnership, limited liability company, or leasing arrangement structured as a conventional business transaction, and claim the credit as an owner (or, in some cases, as a tenant). When these structures are used, special tax structuring is required: (i) if the credits are allocated to a partnership, special rules govern how the credits are shared among the partners; (ii) typically, the investor has to have a "profit motive", meaning that it has to have an expectation of receiving back more cash and tax credits than its cash investment; and (iii) there is a need for "exit strategies" for getting the investor out of the deal. And many tax credits, including this one, are subject to "recapture" if the property is transferred or destroyed within the first five years after it is placed in service. So, it is important to plan out what will be happening with the project over that time period. Finally, since the mid-1980s, when significant changes were made to the Tax Code, credits are generally not as valuable to individuals as they are to corporations. As a result, the latter are far more likely to be investors.

2. **Overview of Section 48C.** The qualifying advanced energy project credit is *not* found in the section that provides the credit for producing *energy* from solar, wind, geothermal, and other renewables that we have discussed in several recent Nixon Peabody *Alert*s. It's an entirely new and different credit based on placing manufacturing equipment in service. Importantly, Section 48C *does not have a grant option*. As a result, if the developer-user of the facility cannot use the credit on its own, then credit monetization structures, such as partnerships or leasing, will be necessary.

   Because the Section 48C credit does not apply to a building or its structural components, investor structures may involve only the equipment portion of the facility generating the credit, and not the "entire" facility.

3. **What qualifies.** The credit applies to a newly defined term, "*qualifying advanced energy project*", which is a project selected by Treasury that re-equips, expands, or establishes a manufacturing facility for the production of:

   - property used to produce energy from renewable resources;
   - fuel cells and microturbines;

- an energy storage system for use with electric or hybrid motor vehicles;
- electric grids to support the transmission or storage of intermittent sources of renewable energy;
- property designed to capture and sequester carbon dioxide emissions;
- property designed to refine or blend renewable fuels (but *not* property which is used in the refining or blending of any transportation fuel other than renewable fuels);
- property designed to produce energy conservation technologies (including energy-conserving lighting and smart grid);
- certain electric vehicles described in Sections 30(d) and 30D of the Tax Code, and components designed specifically for use with such vehicles; or
- other advanced energy property designed to reduce greenhouse gas emissions as determined by Treasury.

The notice provides two additional considerations:

- to qualify as manufacturing, the facility must "make or process raw materials into finished products (or accomplish any intermediate stage in that process", and
- qualifying property must be "necessary for the production of specified advanced energy property"

Thus, based on the foregoing, we wouldn't expect furniture or typewriters used by administrative or sales staff to qualify for the credit.

4. **The credit is competitive.** The government is seeking applications to compete for the award of Section 48C credits. Projects will be ranked by the Department of Energy, and then Treasury will complete the process by awarding credits to those projects on DOE's list, *in order,* until the $2.3 billion of credits has been exhausted. Certain basic criteria are important – first, credits can be awarded only to projects where there is a reasonable expectation of commercial viability. Furthermore, Treasury is directed to choose the projects that meet several evaluation criteria. These are enumerated in the notice, as follows:

   - greatest direct and indirect domestic job creation during the period February 17, 2009 through February 17, 2013;
   - greatest net impact in avoiding or reducing air pollutants and greenhouse gases;
   - greatest potential for technological innovation and commercial deployment, based on three subfactors, the production of new or significantly improved technologies, improvements in levelized costs or performance, and "manufacturing significance and value"
   - shortest project time from certification to completion.

   A fifth factor identified in the Code, lowest cost of generated or stored energy, reduction in energy consumption, or greenhouse gas emission, is not listed with the others in the notice.

   The notice grafts some additional scoring criteria onto this process, which it refers to as "program policy factors" and which are ranked equally:

- geographic diversity
- technology diversity
- project size diversity, and
- regional economic development.

Finally, although this factor does not appear in the statute, the application materials do call for an applicant to compute energy and environmental impacts "per tax credit dollar". So, it will likely be important for an applicant to be efficient in structuring and pricing its project.

How it will actually work:

1. **The need for speed**. When Jim Duffy and I met with Treasury in July, it was apparent that Treasury was directed to get the Section 48C process underway quickly. They were concerned that dividing the $2.3 billion in tax credits into multiple rounds of applications, or reserving credits for particular industries, might delay deployment of this credit or leave some of it unused if a particular industry did not pursue credits or score well in the application process. Consistent with this view, Treasury's guidance is based on a single round of applications, with more rounds only if the credits fail to be fully italicized, and very short deadlines that will require taxpayers to act very quickly if they want to compete for the Section 48C credit.

   The first deadline arrives in the very near future: an applicant must submit a short, preliminary application, identifying the kind of project, its current status, and milestones for completion; this is due to the Department of Energy by September 16, 2009. Next comes a far lengthier "final" application, with a detailed business plan and projections. This is due just one month later, on October 16. It's not clear, but it appears that October 16 is an applicant's last chance to describe how its project meets the 48C criteria. Finally, an application to the IRS must be submitted no later than December 16. The IRS has not yet published the form of this last application. Note that Treasury decided against a rolling process for accepting applications. In other words, it's crucial that each step of an application be submitted by its particular deadline, but it's not beneficial if it is received ahead of other applications.

   Treasury has specifically incorporated the filing provisions that apply to tax returns in accepting applications. So, the use of a local post office or an approved delivery service may be the best way to assure that an application has met the deadlines. All applications must be signed under penalties of perjury by an authorized signer.

2. **Little flexibility**. That doesn't mean that an application won't benefit from being completed as soon as possible. The notice is filled with reminders that the IRS will not be able to extend deadlines, that failure to include all required information may cause an application to be rejected, that significant changes in an actual project from the description that was submitted may result in denial or recapture of credits, and that there is no right to a conference or appeal. Treasury has adopted a broad standard on changing the project – anything that a reasonable person would expect the Treasury or DOE to consider "significant" must be brought to their attention. Overall, Treasury has detailed a tough process, suggesting that asking lots of questions as early as possible, and trying to resolve any doubts before the deadlines will be important.

3. **Business plans and similar materials**. DOE wants to see a lot of material in the October 16 application – in particular, a business plan, the experience of an applicant's officers and directors, and its other sources of cash. In a lot of ways this looks just like the materials that companies provide to potential investors. Plainly, companies that have put thought into these materials and have them already prepared will have a large advantage.

Companies that are in the preliminary stages, with a clever idea but little else, are not likely to do well in this process. It is generally expected that these materials will be submitted on a pair of duplicate CDs.

4. **The tax angles**. Some taxpayers may be able to use the credit directly against their own tax liability, but others will want to use (i) partnership structures like we see for traditional renewable energy projects; and (ii) leasing structures, using both finance and "lease-passthrough" (or "inverted lease") structures. Of course, this means that applicants intending to utilize partnership or leasing structures will have to be attentive to the credit allocation rules of the Tax Code and regulations, as well as the profit motive and other principles that govern the allocation of tax benefits to an investor. Furthermore, as we noted earlier, many other tax credit rules apply – accordingly, tax-exempt partners can be a problem, as can individual investors, who may be subject to the passive loss or at risk rules. Finally, the placed in service date is critical to allocating the credit to an investor – in most cases, it is essential that the investor be identified in advance of the placed in service date and be part of the ownership structure, unless the 90-day window afforded to sale-leasebacks applies, and even then, we're facing a short time-frame.

   I asked Treasury whether an application will be considered changed in a "significant" way if it didn't describe a partnership or leasing structure, but an investor is found and admitted a good deal later, long after the application was approved by DOE and Treasury. The answer was a very clear "no," provided the successor to the credits signs the same agreement with Treasury that is required of the original award recipient.

   One last observation – the notice specifically observes that the award of credits by the DOE-Treasury process does *not* prevent Treasury from later auditing the transaction. So, tax opinions, accountants certifications, and care in actually building and operating the project are important.

5. **The longer term calendar.** Actually qualifying for the 48C credits is a multi-step process. When an application is ranked high enough by DOE to merit an award of credits by Treasury, Treasury will issue an "acceptance letter". Treasury expects all letters to go out by January 15, 2010, for applicants to execute an agreement with Treasury by March 15, 2010, and for Treasury to also execute the agreement by April 16, 2010. The taxpayer has one year from the date of the acceptance letter to get *all* federal, state, and local permits and otherwise demonstrate that the project is on pace to be placed in service within another three years. At this point, Treasury will "certify" that the project is eligible for credits, and the applicant has three years to place the project in service. As the notice observes on page 2, "If the taxpayer does not place the project in service by the end of that period, the certification is no longer valid. *The Internal Revenue Service has no authority to extend that period."*

   Left unsaid is how the IRS will handle projects that are partially completed. Remember that projects consist of equipment, not buildings. So, what happens if a project calls for 100 machines, and 70 are installed by the three-year deadline. Is that a "significant" change from what the applicant represented? Does the applicant lose some or all of the credits on these facts?

We'll be providing more guidance as it emerges from Treasury and the Department of Energy.

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