

Energy Projects Continue to Qualify for Tax Credits, Tax Grants Extended Another Year

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Theodore B. Howell

David C. Morganelli, Esq.

The tax credits enacted during the Bush administration to promote development of alternative energy sources are still available. More importantly, the start date for renewable energy projects eligible for the tax grant program (TGP) enacted during the Obama administration has been extended to December 31, 2011. Both the investment tax credit and the production tax credit, which have been used heavily in recent years by the energy industry, continue to be available for eligible entities. Thus, we can expect continued investment in an already robust sector. In fact, according to the Solar Energy Industries Association (SEIA), the TGP spurred over 1,100 solar projects and \$18 billion dollars of investment in 2010.

The Federal Investment Tax Credit (ITC)

The ITC is an upfront credit against the capital expense used to build out a project. The Internal Revenue Code provides an ITC for certain types of commercial energy projects, including solar, fuel cells and small wind projects (all of which are eligible for a credit equal to 30% of the project's qualifying costs), as well as geothermal, microturbines,

and combined heat and power projects (all of which are eligible for a credit equal to 10% of the project's qualifying costs). The ITC for fuel cells and microturbines is subject to a dollar cap, while the other technologies are not currently capped. In general, the ITC is currently available to qualified projects that are placed in service prior to the end of 2016, though the geothermal credit has no expiration date, and the solar credit will (unless otherwise extended) revert to 10%, rather than expiring altogether, at the end of 2016.

The ITC is realized in the year in which the project begins commercial operations, but vests linearly over a 5-year period. Thus, if the project owner sells the project before the end of its fifth year of operations, the unvested portion of the credit will be recaptured by the IRS. In addition, for every dollar of ITC claimed, the taxpayer must reduce the depreciable basis of the property by 50 cents. The ITC is often sold to third party investors in which case a discount of 15% to 20% should be factored into total financing costs.

The Federal Production Tax Credit (PTC)

The production tax credit is a credit over time based upon the amount of energy produced, and has typically been utilized by developers of large scale renewable energy projects. As authorized by the Energy Policy Act of 1992 and amended over time, Section 45 of the Internal Revenue code provides a 10-year, inflation-adjusted production tax credit for power generated by certain types of renewable energy projects, including wind, closed-and open-loop biomass, geothermal, landfill gas, municipal solid waste, qualified hydropower, and marine

and hydrokinetic facilities. The renewable electricity production credit generally equals 1.5 cents (\$.015) multiplied by the kilowatt hours of renewable electricity produced and sold by the taxpayer, increased by an inflation factor. If the taxpayer sells electricity produced from both open-loop biomass and other fuels, the credit is reduced to an amount equal to the otherwise allowable credit multiplied by a fraction, the numerator of which is the thermal content from open-loop biomass and the denominator of which is the thermal content of all the fuels. Currently, wind projects placed in service before the end of 2012 will be eligible to receive the 10-year PTC, while the other renewable technologies have an additional year to come online (i.e., until the end of 2013). Various rules and regulations surround the use of the PTC. For example, to qualify for the PTC, the power must be sold to an unrelated party. Furthermore, certain limitations exist on the use of the PTC in combination with other public sector incentives, including grants, tax-exempt bonds, subsidized energy financing, and other federal tax credits.

Federal Grants In Lieu of Tax Credits

Pursuant to The American Recovery and Reinvestment Act, developers of some projects which may have previously only qualified for PTCs were given the opportunity to elect to receive ITCs. Furthermore, all developers were given the opportunity to receive tax grants from the Treasury Department in lieu of ITCs pursuant to the TGP. Initially, such projects had to be commenced by December 31, 2010, but legislation passed this December extended that date to December 31,

2011. Such grants are given in lieu of ITCs, and any taxpayer receiving the grant is ineligible to receive ITCs or PTCs for the specified project. The following taxpayers are ineligible to receive an energy grant: (1) a federal, state, or local government, including any political subdivision, agency, or instrumentality thereof; (2) any Internal Revenue Code §501(c) organization that is exempt from tax under §501(a); (3) a cooperative electric company; (4) a clean renewable energy bond lender; and (5) a partnership or other passthrough entity that is a direct or indirect owner of one of the entities described in the first four tests, unless the indirect ownership is held through a C corporation. Eligibility is determined as of the time the application is received. Furthermore, there are time limits as to when the project must be placed in service in order to qualify for the grant.

Factors To Consider

The type of energy project in question may determine the availability of the ITC, PTC or TGP, as well as which is most beneficial. Smaller developers may prefer the liquidity that comes through grants or the sale of the future value of tax credits. Projects that require heavy upfront investment may prefer the ITC over the PTC. For wind projects, as the projected energy capacity per wind turbine increases, the more likely it is that the PTC will generate greater cash flows over the long term.

A thorough analysis requires weighing the cost of equipment versus projected production rates. As technology becomes more efficient, and capital costs decrease, more energy can be derived out of less

investment. The tax credits resulting from increased production may become greater than those resulting from the investment.

Conclusions

The choice of a cash grant, the ITC or PTC will have to be made on a project-by-project basis in accordance with the available capital and investment data, the projected production, as well as the preferences of the developers and investors.