



the new green

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To: RED
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Re: Investment and Productive Tax Credits for CHP and Biomass Facilities
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CHP Investment Tax Credit IRC § 48 and Accelerated Depreciation IRC § 168

Combined heat and power (CHP) property qualifies for a 10-percent investment tax credit (ITC) under section 48(a)(3)(A)(v). The ITC is equal to 10 percent of the costs of the first 15 megawatts of qualifying CHP “energy property”.¹ Eligible CHP property includes systems up to 50 MW in capacity that exceeds 60% energy efficiency. To qualify, the original use of the equipment must begin with the taxpayer or it must be constructed by the taxpayer. Energy property must be operational in the year in which the credit is first taken. The ITC terminates on January 1, 2017.

CHP and other energy property, as defined under section 48(a)(3)(A), also qualify for accelerated depreciation. Section 168(e)(3)(B)(vi)(I) sets out that “5-year property includes...any property which is described in subparagraph (A) of section 48(a)(3).” Section 168 of the Internal Revenue Code provides a Modified Accelerated Cost Recovery System (MACRS) through which “energy property” qualifies for a five-year, depreciation method.

Because there is no guidance yet for CHP property, the depreciation of a wind project can illustrate how the MACRS works. A typical rule of thumb is that 90% of a wind project’s total costs qualify as “energy property” eligible for 5-year MACRS depreciation, with the remaining 10% depreciable over 15 years. Assuming a half-year convention, the 5-year MACRS depreciation schedule for “energy property” is spread over six years as follows: 20%, 32%, 19.20%, 11.52%, 11.52%, 5.67%.

Biomass Production Tax Credit IRC § 45

Section 45 provides for a production tax credit (PTC) from “qualified facilities” that generate energy from “qualified energy resources.” Qualified energy resources include: closed-loop and open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste and certain qualified hydropower production, and now with the recent extension hydrokinetic energy. Closed-loop biomass is any organic material from a plant that is planted exclusively for use at a qualified facility to produce electricity.² Open-loop biomass includes

¹ Qualified fuel cell, geothermal equipment and micro turbine property are eligible for a 30 percent ITC.

² IRC § 45(c)(2).

solid, nonhazardous, cellulosic waste material, lignin material, or agricultural livestock waste nutrients.³

Electricity produced from closed-loop biomass receives full credit while open-loop biomass is eligible for half credit. The full-credit rate was originally set at 1.5¢ (indexed annually for inflation), multiplied by kilowatt hours of electricity produced by the taxpayer – beginning on the date the facility was originally placed in service. The credit is currently around 2.0¢/kWh, so facilities receiving half credit (open-looped biomass) get approximately 1.0¢/kWh. Projects are deemed to have been originally placed in service on the date they are placed in a condition or state of readiness and availability to produce electricity.⁴

The production tax credit's duration depends on the facility. For closed-loop biomass, credit is earned for production in the first ten years, starting from the facility's original placement-in-service date.⁵ For open-loop biomass, credit is earned for production in the first five years.⁶ Changing the facility's ownership will not alter the coverage period for biomass projects.

Taxpayers must meet two general requirements to earn credit for electricity production. First, the taxpayer must be the owner and produce the electricity at a qualified facility placed in service within the eligible period. Second, the taxpayer must sell the electricity to an unrelated person. There is an exception to the ownership rule which is applicable to biomass facilities; where the owner of the biomass facility is not the producer of electricity, the person eligible for the credit is the lessee or operator of the facility.

The eligibility period for all biomass facilities ends on January 1, 2011.⁷ Credits offset regular tax liability for the first \$25,000 and offset 75 percent over that. Unused credit has a 1-year carryback and 20-year carryforward.

Anti-Double Dipping Rule

The anti-double-dipping rules are complicated and remain a bit unclear. It appears that a biomass CHP project is precluded from taking both the PTC and ITC. In fact, it appears that a biomass CHP project must take the PTC rather than the ITC. Section 48(a)(3) states that qualifying energy property does not include “any property which is part of a facility the production from which is allowed as a credit under section 45 for the taxable year or any prior taxable year.”

³ IRC § 45(c)(3) .

⁴ § 1.46-3(d)(1)(ii)

⁵ Other facilities that qualify for the 10-year period include: wind, trash combustion, refined coal production and qualified hydropower.

⁶ Facilities that qualify for the 5-year period include: geothermal, solar, small irrigation and landfill gas.

⁷ Wind and refined coal production facilities were only extended one year until January 1, 2010. Whereas open-loop and closed-loop biomass, geothermal, small irrigation, landfill gas, trash combustion and qualified hydropower facilities were extended for two years until January 1, 2011.

However, it does appear clear that if a biomass project receives other incentives, such as a federal grant or tax-free bond, the production tax credits from section 45 will be reduced by the “anti-double dipping” or “haircut” provision, which reduces the PTC’s size in proportion to the aggregate amount of “offending” dollars that a project receives over time relative to its overall capital cost (with the proportion not to exceed 50%).

Specifically, section 45(b)(3) reads:

The amount of the credit...for any taxable year...shall be reduced by the amount which is the product of the amount so determined for such year and the lesser of 1/2 or a fraction –

(A) the numerator of which is the sum, for the taxable year and all prior taxable years, of –

(i) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the project,

(ii) proceeds of an issue of State or local government obligations used to provide financing for the project, the interest on which is exempt from tax under section 103

(iii) the aggregate amount of subsidized energy financing provided (directly or indirectly) under a Federal, State, or local program provided in connection with the project, and

(iv) the amount of any other credit allowable with respect to any property which is part of the project, and

(B) the denominator of which is the aggregate amount of additions to the capital account for the project for the taxable year and all prior taxable years.

The “haircut” is a proportional, rather than dollar-for-dollar, reduction of the credit calculated as the aggregate amount of offending dollars divided by the capital cost of the project, and capped at 50%.

The legislative history suggests the purpose of the “haircut” provision is to prevent inefficient projects that rely solely on government assistance.⁸ In Revenue Ruling 2006-9 the IRS found that state and local tax credits are not considered in the section 45 offset. In the ruling they also suggest the term “any other credit allowable” in section 45(b)(3)(A)(iv) includes only federal tax credits allowable under the Code with respect to property that is part of a project.

⁸ Congress explained the rationale for anti-double-dipping rules in the conference report to the Crude Oil Windfall Profits Tax Act of 1980: “The conference agreement provides rules to coordinate the business energy credits with other government subsidies for energy-related expenditures. The conferees are concerned that if no such rules were adopted, the compound effect of various subsidized loan and grant programs could lead to a situation in which the taxpayer could purchase this property with very little expenditure of his own funds. A potential result could be the encouragement of inefficiency through expenditures for equipment the production of which would require diverting substantial resources from more effective uses. The effect of the rule provided in the conference agreement, in conjunction with the present treatment of nontaxable grants, is that the purchaser of the eligible equipment must choose between the tax credit, on one hand, and subsidized energy loans and nontaxable grants, on the other hand. Grants which are taxable are not taken into account under these rules because their taxation serves as a partial offset; similarly, credits against State and local income taxes are not taken into account because the deductibility of these taxes under the Federal income tax implies that the effect of these credits is equivalent to the effect of a taxable grant.”

In Private Letter Ruling 200202048 (October 10, 2001), the IRS described the subsidies which offset the section 45 credit as those financing the project's capital cost. The IRS said "that § 45(b)(3) requires a reduction in credit in proportion to a facility's capital cost which is financed by government grants, proceeds of government issued tax-exempt obligations, subsidized energy financing under a government program, and any other credits." In other words, the IRS recognized that the grants, bonds, and financing assistance which offset the section 45 credit must relate to the capital construction and acquisition expenses. Subsequently, Private Letter Ruling 200837028 (June 22, 2008) reiterated that "section 45(b)(3) requires the credit amount determined under § 45(a) to be reduced by the amount of grants, tax-exempt bonds, subsidized energy financing, and other credits received by a taxpayer as of the close of the taxable year with respect to any project for any taxable year."

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