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Renewable Energy Tax Reform - Where Are We Today?

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> *"The most damaging thing you can do to a businessman in America is to keep him in doubt, and to keep him guessing, on what our tax policy is [today]"*
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> - Lyndon B. Johnson (1964).

Tax reform, including renewable energy tax incentives, are currently a hot area for debate in Congress. Many of the most important tax incentives relating to renewable energy sources, including the Production Tax Credit ("PTC") and the Investment Tax Credit ("ITC"), expired at the end of 2013 or are about to expire.

On December 3, 2014, the House of Representatives overwhelmingly approved a $41.6 billion tax extenders bill (Tax Increase Prevention Act of 2014 (H.R. 5771)) that will likely become law as both President Obama and the Senate Finance Committee have apparently indicated their reluctant approval of the short-term extension (one-year) of over 50 expired tax provisions (including the PTC) retroactive and through December 31, 2014.[1] Although it could have been better, this is likely welcome news for certain taxpayers, including those wondering whether their facility or plant properly qualified for the PTC (or ITC if elected) as of December 31, 2013 (the prior deadline for eligibility).[2]

Nevertheless, a one-year extension through 2014 is less than what the Senate was seeking (*i.e.*, a 2-year extension through 2015) and not a long-term solution by way of comprehensive tax reform as previously proposed by all of the political parties.

This Alert will: (i) provide a primer on the PTC and ITC; (ii) provide a summary of the most recent IRS guidance regarding the eligibility for the PTC and ITC; and (iii) briefly address a few of the better known legislative proposals currently before Congress and their position as it relates to renewable energy tax credits, including notably the PTC and ITC.

I. The Production Tax Credit and Investment Tax Credit - Background.

A. IRC Section 45- Production Tax Credit (PTC).[3]

The renewable energy tax credit, also known as the Production Tax Credit (PTC), is an investment tax credit allowed for energy generated from qualified energy sources (by kilowatt hour) at a qualified facility that the taxpayer sells to an unrelated party.[4] The period for the credit is generally a 10-year period beginning on the date the facility is placed in service.

[1] *See* Cooper, Stephen K, *"House Passes Extender's Bill, Wyden Gives Up on Alternative,"* Tax Notes Today, December 4, 2014.
[2] More specifically, as discussed below, to be eligible for the PTC, construction must have begun on a qualified facility or project on or before January 1, 2014. Under the new law, if passed, construction must have begun on or before January 1, 2015. *See* Section 155 of the bill, Tax Increase Prevention Act of 2014.
[3] The title of Internal Revenue Code ("IRC") Section 45 is: *"Electricity Produced From Certain Renewable Resources."* The PTC is computed on IRS Form 8835, Renewable Electricity Production Credit.
[4] *See* IRC Sections 45(a) and (c).

It is well established that the PTC has been a major driver of renewable energy development. The PTC is available for energy generated from several sources, including but not limited to wind, closed-loop biomass, refined coal, geothermal energy, solar energy, municipal solid waste, or qualified hydropower production.[5]

The PTC expired on December 31, 2013 (unless construction began before January 1, 2014), but as discussed below, will likely be extended retroactively through 2014 and possibly, but very unlikely, through 2015.

B. IRC Section 48 - Investment Tax Credit (ITC).[6]

To encourage energy conservation measures, a business energy credit (ITC) is available to businesses that invest in energy conservation properties. Unlike the PTC, electricity can be produced for the taxpayer's own use. (The ITC is based on the cost of a qualifying facility, not on how much electricity is produced as under the PTC.)

The ITC is an alternative to the PTC discussed above. By electing this one-time up to 30% (of depreciable acquisition cost) ITC credit, the taxpayer forgoes the PTC under IRC Section 45.[7] Until and unless the law changes, the irrevocable election must be made for any qualified facility placed in service after 2008 and the construction of which begins before January 1, 2014 (and January 1, 2015 if the Tax Increase Prevention Act of 2014 is passed as currently drafted).[8]

Similar to the PTC, the ITC applies to a number of different facilities including wind, closed-loop biomass, and geothermal.

Except as noted above, the ITC expired effective December 31, 2013 for certain renewable energy projects (*e.g.*, wind, hydropower) and will expire on December 31, 2016 for others (*e.g.*, solar, geothermal).

II. Recent IRS Guidance - IRS Notice 2014-46.

Previously, on January 2, 2013, the American Taxpayer Relief Act of 2012 ("ATRA") was enacted. ATRA replaced the "placed in service" by December 31, 2013 requirement under Section 45 related to the eligibility for the IRC Section 45 PTC with the requirement that construction on those facilities must begin prior to January 1, 2014 (the "Start of Construction Requirement").[9] Although such change by the ATRA was a welcome relief to many developers as it extended the opportunity (time) to claim PTCs, it also created some uncertainty regarding when construction of a renewable energy project actually had begun for the purpose of being eligible for the PTC under the revised Start of Construction Requirement.

For the purpose of assisting developers of such projects, during the tax year 2013, the IRS issued Notices 2013-29 and 2013-60 (the "Prior Notices"). Such Prior Notices established two methods by which a developer could verify that construction had begun by the statutory deadline of January 1, 2014 on a qualified facility, and therefore satisfy the Start of Construction Requirement, including: (i) the "Physical Work Test" (physical work of a significant nature and has made continuous progress towards completion once construction has begun); and (ii) the five-percent "Safe Harbor" (developer incurs 5% of total project costs by January 1, 2014 and has made continuous progress towards completion once construction has begun).

Such Prior Notices were helpful, but still created some uncertainty regarding how the Physical Work Test and Safe Harbor were properly satisfied. As a result, recently, on August 8, 2014, the IRS issued a third related notice, Notice 2014-46 (the "Notice"), which provided some very helpful guidance by way of modifying and clarifying the Prior Notices.

[5] Such sources meet the requirement for a "qualified energy resource" and "qualified facility."
[6] The title of IRC Section 48 is: *"Energy Credit."* The ITC is claimed on Form 3468, Investment Credit.
[7] *See* IRC Section 48(a)(5).
[8] *See* Notice 2014-46.
[9] *See* IRC Section 45(d). Such change in requirement also applies to the Section 48 ITC if chosen in lieu of the Section 45 PTC.

The Notice clarified that under the Physical Work Test, the focus is on the type of work performed, not its cost (*i.e.*, a qualitative approach). Also, and most importantly, the Notice provided that both the Physical Work Test and Safe Harbor will be deemed satisfied if the project is placed in service by January 1, 2016, regardless of the amount of physical work performed or the cost paid or incurred with respect to the facility between December 31, 2013, and January 1, 2016. Stated another way, as long as the facility is placed in service by January 1, 2016, the requirement of continuous progress towards completion of the project is met even if construction stalled or completed stopped for whatever period of time and for whatever reason. Lastly, the Notice confirms the ability of taxpayers to transfer facilities after construction has begun.

III. Possible Tax Legislation - Energy Incentives, Including the PTC and ITC.

"Current U.S. energy tax policy is a combination of long-standing provisions and relatively new incentives . . . Incentives for renewable energy reflect the desire to have a diverse energy supply, also consistent with a desire for domestic energy security. Incentives for energy efficiency are designed to reduce use of energy from all energy sources. Incentives for renewable energy, energy efficiency . . . reflect environmental concerns."[10]

The future of the PTC and ITC depends on Congressional action. At this time, the 114th Congress is in session. As stated above, tax reform, including renewable energy tax credits, including the PTC and ITC, are topics that will be addressed. The following provides a summary of the most likely short-term fix, as well as a few tax proposals for long-term resolution, as it relates to the PTC and the ITC.

A. Short-Term Fix. As of this time, Congress and the President have not officially extended any of the approximately 50 plus tax provisions that expired on January 1, 2014. Nevertheless, action appears to be taking place in Congress. For example, most recently, and as noted above, on December 3, 2014, the House of Representatives overwhelmingly approved a $41.6 billion tax extenders bill[11] that appears will become law and includes a provision for the PTC (and ITC if elected in lieu of the PTC).[12]

Previously, also as a positive step forward, the U.S. Senate Finance Committee (but not the entire Senate) approved the Expiring Provisions Improvement Reform and Efficiency Act (the "EXPIRE Act") which includes a 2-year extension for the PTC (as well as the election to claim the ITC in lieu of the PTC), among 50 plus other provisions that expired at the end of 2013. More specifically, the EXPIRE Act would retroactively extend the PTC from January 1, 2014 to December 31, 2015. Unfortunately, as noted at the beginning of this article, a two-year extension is likely not going to happen.

In short, it appears hopeful that the PTC (and ITC if elected in lieu of the PTC), at a minimum, will be extended another one year through all of 2014.

B. Long-Term Fix - Current Tax Proposals. There are three leading tax proposals that address renewable energy tax credits, including: (i) the then Chairman of the U.S. Senate Finance Committee, Max Baucus, "Discussion Draft" on energy tax reform (the "Baucas Proposal"); (ii) the House Ways & Means Chair Dave Camp proposal (the "Camp Proposal);" and (iii) President Obama's 2015 Budget proposal (the "Presidents' Proposal"). Each of the three proposals is discussed below.

1. Baucas Proposal. On December 18, 2013, the then Chairman of the U.S. Senate Finance Committee, Max Baucus, released a staff Discussion Draft on energy tax reform.

[10] *See* Sherlock, Molly F. "CRS [Congressional Research Service] Examines Expiring Energy Tax Incentives," dated September 4, 2013.
[11] The *"Tax Increase Prevention Act of 2014 (H.R. 5771)."*
[12] Apparently, both President Obama and the Senate's Ron Wyden (D-OR), Senate Finance Committee Chair, have apparently indicated their unofficial approval of the short-term extension of over 50 expired tax provisions (including the PTC) retroactive and through December 31, 2014.

In the Discussion Draft, it states that "[D]espite the importance of [clean energy], our current energy incentives are overly complex and far less effective than they could be. Today, there are over 42 different [energy] tax incentives. More than half are too short-term to effectively stimulate investments. They also provide different subsidies to different technologies with no discernable polity rationale. On top of that, they result in significant revenue loss; if we continue to extend current incentives, they will cost nearly $150 billion over ten years. To address these issues, this Discussion Draft proposes a dramatically simpler set of long-term energy tax incentives that are technology-neutral and promote cleaner energy that is made in the United States."

Thus, the Baucas Proposal would replace electricity incentives (PTC and ITC) with "technology neutral" incentives based on efficiency (*i.e.,* a new PTC and ITC regime). The Baucas Proposal, however, would extend the ITC to facilities placed in service through 2016.

(Note: Most recently, on September 17, 2014, the Senate Finance Committee held a hearing to discuss the need for reforming the nation's outdated energy tax laws as part of the larger tax reform debate. According to current Chairman of the Senate Finance Committee Ron Wyden (D-OR), and continuing the thrust of the Baucas Proposal, he stated that *"[i]t is past time to replace today's crazy quilt of more than 40 energy tax incentives with a modern, technology-neutral approach,"* noting Congress's habit of *"passing temporary extensions of those incentives, shaking hands, and then heading home" . . . "Clean energy projects take time to plan and finance . . . Predictable, level-playing-field tax policies could clear the way for America's clean energy sector to thrive at home . . .."*)

2. The Camp Proposal. On February 26, 2014, Dave Camp (R-MI), Chairman of the House Ways & Means Committee, unveiled his long awaited comprehensive tax reform package, called the Tax Reform Act of 2014, which is one of the most detailed tax reform proposals in the last 25 years (the Camp Proposal). The Camp Proposal, however, has apparently not gained much traction. Among other things, the Camp Proposal calls for a reduction in corporate and individual income tax rates.

Although the Camp Proposal pushes for a permanent extension of many of the 50 plus tax provisions that expired at the end of 2013, the Camp Proposal apparently phases out or repeals most of the targeted energy provisions, including the PTC and ITC. As for the PTC, it would be repealed entirely for electricity produced and sold after December 31, 2024. The ITC would be repealed for property placed in service after 2016.

3. President's Proposal. President Obama's 2015 Budget (the President's Proposal), released shortly after the Camp Proposal on March 4, 2014, focuses more on corporate tax reform and seeks to raise revenues for spending.

The President's Proposal includes a permanent PTC and will make it refundable for facilities on which construction begins after December 31, 2014. By making the PTC refundable, taxpayers without a tax liability will have an incentive to produce renewable energy. For the most part, the ITC would be allowed to expire.

In short, the President's Proposal signals a strong support for renewable energy.

IV. Summary/Conclusion. Because the PTC and ITC have expired, but Congress is known to retroactively reinstate expired provisions, including talk of extending the PTC retroactive through 2014 and possibly (although unlikely) through 2015, it has created much uncertainty for taxpayers contemplating building a renewable energy facility. The 114th Congress is currently in session and it is hopeful it will at least provide a short-term fix to the PTC which will provide a minimum of certainty for taxpayers. Nevertheless, a long-term solution and certainly as to future renewable energy tax credits, including the PTC and the ITC, is necessary, whether good news or bad. There are three viable tax proposals currently on the table. The one proposal that does not support renewable energy (at least as to tax incentives) is the Camp Proposal. Both the President's Proposal (more of a status quo) and the Baucas Proposal (a revamping of the 40 plus renewable energy credits) signal support for renewable energy.

It is hopeful that one these latter proposals, or a mix of the two, provide the incentives for increased renewable energy projects. Stay tuned.

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