

# Risks, Requirements And Benefits Of The New Tax Credits

The DOE and the IRS are expected to dole out up to \$2.3 billion in renewable energy manufacturing tax credits.

■ John Marciano & Eli Katz

Just a few days before the six-month deadline set by Congress back in February, the U.S. Internal Revenue Service (IRS) and the U.S. Department of Energy (DOE) issued rules in mid-August for what promises to be a cornerstone subsidy for developing alternative energy technologies in the U.S.

This subsidy offers up to \$2.3 billion of tax credits to any company that spends money to build a new manufacturing facility or to re-tool, expand or rebuild an existing facility that will make renewable energy equipment. The credit is for 30% of the money spent to build the facility, which must be located in the U.S.

This credit complements two other alternative energy subsidy programs: the cash-grant program and the DOE's loan-guarantee program. The cash-grant program offers a cash subsidy for investing in equipment that generates renewable energy, while the DOE loan-guarantee program offers to guarantee a portion of the debt used to finance many forms of alternative energy investments.

A simple initial application was due Sept. 16. Applicants that are selected to receive an allocation of the



*A residential PV installation in San Rafael, Calif. Photo courtesy of SolarCity*

credit can use it when the facility is completed or "placed into service" under the tax rules. That event must happen within three years of the date when the IRS certifies the project.

For facilities that take over two years to build, however, a special rule allows the credits to be meted out throughout the construction period.

However, in either case, the taxpayer cannot claim the credit before the IRS allocates a specific dollar amount of the credit to the taxpayer. It can claim the credit only to the extent of that allocation.

Congress has identified six broad categories of equipment that it thought were needed to transition to a more sustainable economy. A project can qualify for the new tax

credit if it is designed to manufacture equipment in one or more of the following categories:

■ Electric generation equipment that uses renewable sources, such as wind, the sun or geothermal deposits;

■ Fuel cells, micro-turbines or a battery system for use with electric or hybrid-electric motor vehicles;

■ Transmission equipment that will be used with intermittent renewable energy sources (e.g., wind and solar);

■ Energy-storage equipment (e.g., batteries) that can be used with those intermittent energy sources;

■ Property that is designed to capture and sequester CO<sub>2</sub> emissions;

■ Renewable fuel refining or blending equipment, including en-

energy efficiency items, such as energy-conserving lighting and smart grid technologies); and

■ New plug-in electric vehicles or components that are designed specifically for use with those vehicles, including electric motors, generators and power control units.

At the same time, if the property does not fit neatly into one of the six categories, it may still qualify for the tax credit in certain cases, as determined by the DOE.

The final application will be due Oct. 16. Then, an applicant must have its project recommended and ranked by the DOE. The company needs to apply to the IRS for certification of the project and the allocation of the credit.

Certifications and credits will be issued in two allocation rounds - in 2009-2010, and then in 2010-2011, if any credits remain.

There is no bright-line test that will guarantee that an applicant will receive a credit allocation. The DOE will recommend and rank a project that it determines to have a reasonable likelihood of commercial viability and merits a recommendation. However, Congress has provided a list of factors for the DOE to consider in its ranking process.

The primary focus will be on job creation from Feb. 17, 2009, to Feb. 17, 2013 (i.e., the number of jobs created per \$1 million of tax credits). Both construction and operational jobs are considered, and the analysis will also take into account indirect jobs, which may be further down or up the supply chain.

The DOE will consider several other factors of lesser importance, such as the net impact on greenhouse gas (GHG) emissions or other air pollution (individually and through the supply chain); the potential for technological innovation and commercial deployment (including the production of new, significantly improved or cheaper technologies); the cost of gener-

ated or stored energy or a reduction in energy consumption or GHG emissions (based on costs of the full supply chain); and the shortest projected time from certification to completion.

The IRS has indicated informally that it will not consider bringing in an investor to monetize the tax credit to be a significant deviation from the application. Thus, even though the guidance suggests some risk of denial or recapture of the credit in that case, the IRS seems inclined to follow a more reasonable path.

In addition, the application guidance requests a financial model detailing investments in the project, as

the ranking until the allocation limit is exhausted or each applicant in the ranking receives an allocation - whichever occurs first.

For the first round, the IRS expects to accept or reject applications for certification by Jan. 15, 2010, and will notify applicants by letter. If successful, the letter will include the amount of the credit allocation that the taxpayer received.

A taxpayer that receives an allocation must agree to certain terms that the IRS dictates by March 15, 2010. The IRS will execute the agreement by April 16, 2010. The agreement applies only to the taxpayer that signed it. Any successor has to

### The IRS may disallow the credit if the taxpayer changes its plans for the facility.

well as cashflows generated and anticipated over the project's expected life cycle, with an explanation of the facts, assumptions and methodologies. The model also must estimate the project's expected soft costs.

The same issue arises with the requirement that the taxpayer submit a description of the amount and timing of any off-take agreement, along with the financial strength of the potential off-takers. This brings about a real risk that the taxpayer could deviate substantially from the application if an off-take agreement falls through during the construction process.

### Ranking the projects

Because the IRS will consider only projects that the DOE recommends and ranks, the key step will be getting through the DOE process. The IRS will determine the amount of the credit that will be allocated to an applicant's project at the time the IRS accepts the application for certification.

The project with the highest DOE ranking will be allocated the full amount of the credit requested. The IRS then will work its way down

execute a new agreement with the IRS. Otherwise, the credit will be forfeited or recaptured.

The taxpayer has one year from the date the IRS sends the award letter to provide the IRS with evidence that the requirements for the IRS to certify its allocation have been met. The evidence must be submitted under penalties of perjury.

The IRS will require the taxpayer to have all federal, state and local permits (including National Environmental Policy Act reviews or assessments) necessary to start construction. The taxpayer also must show that the project will be capable of being placed into service within three years after the IRS issues a certification of the credits that were allocated to the taxpayer.

The IRS will issue a certification of the credits allocated to a taxpayer once the taxpayer presents the evidence that the taxpayer has met all requirements. From that point, the taxpayer has three years to place the project into service.

In the meantime, there are several events that can cause the credit to be

disallowed - even after it has been awarded to an applicant by the IRS.

If the taxpayer claims the credit as it builds the facility, then it may have to return the credits it took to date in any one of three cases: where it fails to receive a certification for the facility, where the facility is not completed within three years after the IRS certifies the facility or where the facility ceases to qualify for the credit.

The IRS also may disallow the credit if the taxpayer changes its plans for the facility in any significant way. A significant change is a change that would have factored into the determination of either the IRS or the DOE to certify or recommend the facility.

Not much is known yet about how strictly the government will apply this test. Many companies are in the preliminary stages of developing their facilities, and their business plans and capital structure are not yet set. Applicants should, therefore, describe their plans as broadly as possible to ensure some flexibility in the future to change plans without forfeiting the credits.

The credits will be reduced if the facility is owned or used by a governmental entity, American Indian tribe, foreign person or tax-exempt entity.

The credit will be disallowed if the taxpayer also claims a credit for the facility under the investment tax credit provisions for energy production, or advanced coal or gasification projects. This requirement should not be a problem for a manufacturer, because it normally would not qualify for those other credits.

There is also a risk that the credit may be recaptured for the five years after the facility goes into service. The credit vests 20% per year during this time.

If the facility ceases to qualify for the credit (e.g., the factory starts producing parts for other applications or stops production altogether), part or all of the credit will be recaptured.

Alternatively, part or all of the credit will be recaptured if the owner disposes of the project, a partner in a partnership that owns the facility sells down its interest by more than one-third, or certain tax-exempt entities take a stake in the facility.

### Monetization

Tax credits are most valuable to companies that have large tax liabilities. Most individuals, limited liability companies (LLCs) or partnerships cannot use tax credits efficiently to reduce their tax liability because of special rules that do not allow investment-type tax credits to be used against tax liabilities on most types of income, such as wages, interest and dividends.

Corporations are usually the best users of tax credits, because they have

In a partnership flip, an investor either purchases an interest in an LLC that owns the facility or makes a contribution to the LLC in exchange for an interest in the LLC. For tax purposes, the LLC would become a partnership when the investor becomes a member.

The economic returns (including the tax credit) - except, possibly, cash - would be allocated 99% to the investor. Once the investor reaches its specified return, its share of the deal would flip down to 5%.

In a sale-leaseback, the manufacturer first places the facility into service. The manufacturer would then sell the equipment to an investor within the next three months and lease it back. (In a partnership flip, the investor must be in a partnership before the project is placed in service. In a sale-leaseback, the investor has

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very few limitations on using tax credits.

On the other hand, many manufacturers are family-owned or, in this market, operate with slim profit margins - which means they may have difficulty using the credit immediately.

Companies that do not owe any taxes in the year they get the credits can store them on their balance sheet until they do owe tax to the government. The credit can be stored as an asset for up to 20 years, but it is an asset that does not increase in value or offer any return to its owner; it has the same value today as it will 10 or 20 years from now.

For this reason, selling the tax credits to an entity that can use them immediately is often the best use of a tax credit. There are three common ways to sell the credit and still retain control over the facility: a partnership-flip transaction, a sale-leaseback transaction and an inverted lease.

up to three months after the project is completed to invest.)

The investor would own 100% of the equipment. The lessee pays rent and shares the value of the government subsidies (tax credits and depreciation) with the investor in the form of a reduced rent.

An inverted lease passes the tax credit to an investor, who leases the facility from the manufacturer. The manufacturer generally maintains operating control of the facility. After the five-year tax credit period is over, the lease term ends, and the facility is returned to the manufacturer. ❧

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**John Marciano is a transactional lawyer at the Washington, D.C., office of Chadbourne & Parke LLP. He can be contacted at (202) 974-5678 or jmarciano@chadbourne.com. Eli Katz is a transactional lawyer at the New York office of Chadbourne & Parke LLP. He can be contacted at (212) 408-1013 or ekatz@chadbourne.com.**

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