

# ClientAlert

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## The New 30% Tax Credit For "Green" Factories

With just a few days left in the six-month deadline set by Congress back in February, the IRS and the US Department of Energy recently put out the rules for what promises to be a cornerstone subsidy for developing alternative energy technologies in the US. 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 retool, expand or rebuild an existing facility that will make so-called "green" equipment. The credit is for 30% of the money spent to build the facility.

Companies that want to apply for these tax credits must now act quickly. A simple initial application is due by September 16th. Miss this deadline and you will be ineligible to participate in the program.

There are only \$2.3 billion worth of these credits, so applying for a credit is expected to be a competitive process. Anyone that wants to claim a credit has to apply to the IRS and the DOE for an allocation.

### The Basics

The credit is worth 30% of new investments in property that is necessary to produce green equipment. The investments can be made in a new facility or in retooling or expanding an existing facility. The facility must be in the US.

In order for facility costs to qualify for the credit, the costs must be for equipment to process raw materials into finished products, or accomplish an intermediate stage in that process, and the equipment must be necessary to the production process.

This credit nicely complements two other alternative energy subsidy programs: the cash grant program and the loan guarantee program administered by the Department of Energy. The cash grant program offers a cash subsidy for investing in equipment that generates renewable energy. The DOE loan guarantee program offers to guarantee a portion of the debt used to finance many forms of alternative energy investments.

The manufacturer's tax credit applies to manufacturing facilities that will make the components to build a wide range of renewable energy projects. It may be combined with a loan guarantee from the DOE. There is no option to take cash instead of a tax credit.

Costs that are eligible for the credit do not have to be incurred directly for a piece of equipment. "Soft" costs are included to the extent that they relate to the eligible equipment. For example, engineering expenses incurred to design a thin-film solar panel printing machine would be included in the cost of that machine and eligible for a credit.

However, investments in land, buildings (unless merely a shell for equipment) and other permanent structures, are not included in the costs on which the credit is calculated.

Also, you cannot get a credit for any cost you incurred before February 17, 2009 or any cost that is deducted on your tax return when it is incurred.

### "Green" Equipment

Congress 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 these 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 are also qualifying.
- property that is designed to capture and sequester CO<sub>2</sub> emissions.
- renewable fuel refining or blending equipment. It also includes 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.

If a property does not fit neatly into one of the six categories, it may still qualify for the tax credit. A taxpayer that believes its facility has the potential to reduce greenhouse gas emissions should therefore apply for an allocation of the credit.

### Timing

Those who receive an allocation of the credit can first use it only when the facility is completed or "placed into service" under the tax rules. That has to 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.

### Applying for an Allocation

The application is a two-step process. The applicant first has to get its project recommended and ranked by the DOE. It then has 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. One will be in 2009-2010, and an additional one will be in 2010-2011, if any credits remain.

The DOE application process has two steps. A preliminary application is due by September 16, 2009. Then a taxpayer must file a final application by October 16, 2009.

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 has a reasonable likelihood of commercial viability and merits a recommendation.

Congress provided a list of factors for the DOE to consider in its ranking process.

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

There are several other factors of lesser importance. They include: the net impact on greenhouse gas 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 generated or stored energy or reduction in energy consumption or greenhouse emissions (based on costs of the full supply chain); and the shortest projected time from certification to completion.

The preliminary application is very simple. It is a two-page short form. It serves only to give the DOE an idea of the types of projects that will be applying for the credit.

The final application digs deeply into the details of your project.

You first have to describe the facility, the amount of the credit you are requesting and the project timeline. Part of this includes a summary of owners, investors and technical partners involved in the project and their capabilities. You also need to describe confirmed or potential customers.

This information merely has to be based on reasonable estimates and assumptions.

The second part of the application is designed to allow the taxpayer to demonstrate that the project will be eligible for the credit -- that is, it will re-equip, expand or establish a manufacturing facility, the facility will produce the appropriate property and the facility is commercially viable.

The second-round application should describe both the property that will be produced and any property of which the property will become a component.

The applicant will have to describe the project economics and present evidence of commercial viability. One way to do this is with a business plan that lists the key management team members, describes the capabilities and track record of the project contractors and suppliers and lays out the capital structure of the venture.

Some of the financial information the application requires might be difficult to provide if it is in the early stages of planning. Being as comprehensive as possible in the application is

important because a significant deviation in plans later on could lead to the disallowance or recapture of the tax credit.

For example, the guidance asks for detailed financial plan showing the amount of equity to be invested and the sources of that equity, equity funding commitments or expressions of interest and the expected total debt obligations and sources.

Showing some flexibility, the IRS 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 guidance requests a financial model detailing investments in the project, and cash flows generated and anticipated over the project's expected lifecycle, with an explanation of the facts, assumptions and methodologies. The model would also have to 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.

### IRS Application

The IRS application window for the first round begins on August 14, 2009 and ends on December 16, 2009. The IRS applications will not be considered before December 16, 2009, so there is no rush to submit this application.

The IRS will consider only projects that the DOE recommends and ranks, so the key step in this process 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 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 January 15, 2010. It will notify the applicant by letter. If successful, the letter will include the amount of the credit allocation that the taxpayer received.

After a taxpayer receives an allocation, it has to 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 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 will have to 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.

## Haircut, Recapture and Disallowance Risks

There are several events that can cause the credit to be disallowed even after they have 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 the 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 yet known 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, 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 credit provisions for energy production, advanced coal or gasification projects. This should not be a problem for a manufacturer because it normally would not qualify for those other credits.

There is 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.

Part or all of the credit would be recaptured if the facility ceases to qualify for the credit (e.g., it starts producing parts for amusement park rides or

stops production altogether). Alternatively, part or all of the credit would be recaptured where the owner disposes of the project, a partner in a partnership that owns the facility sells down his interest by more than one-third or certain tax-exempt entities take a stake in the facility.

### Monetizing the Value of the Tax Credit

A tax credit is an IOU from the IRS that allows anyone who owes taxes to reduce the tax it owes by the amount of the tax credit. Tax credits, therefore, are most valuable to companies who have large tax liabilities.

Most individuals, LLCs or partnerships cannot use tax credits efficiently to reduce their tax liability because of special rules that don't allow investment type tax credits to be used against tax liabilities on most types of income, like wages, interest and dividends. Corporations are usually the best users of tax credits because they have very few limitations on using tax credits.

Many manufacturers are family owned or, in this market, operating with slim profit margins. That means that they may have difficulty using the credit immediately.

Companies that don't 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 in 10 or 20 years. For this reason, selling the tax credits to someone who can use them immediately is often the highest and best use for 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 or an "inverted" lease.

In a partnership flip, an investor either would purchase an interest in a limited liability company that owns the facility or make a contribution to

the LLC in exchange for an interest in the LLC. For tax purposes, the LLC would turn into 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 would place the facility into service. The manufacturer would then sell the equipment to an investor within the next three months after and lease it back. (In a partnership flip, the investor must be in a partner before the project is placed in service. In a sale-leaseback, he has up to three months 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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