

A new stimulus bill presents new opportunities and challenges for facilities generating electricity from biomass

Renewable energy aspects of the American Recovery and Reinvestment Act

On 17 February 2009 President Obama signed into law the American Recovery and Reinvestment Act of 2009, a \$787 billion (€562 billion) economic stimulus package that contains numerous tax provisions related to biomass and other renewable energy projects.

These provisions present significant new opportunities for developers and investors in biomass projects, but also present new challenges to be resolved over the coming months and years.

Perhaps the most significant biomass-related provision in the act is the extension of the production tax credit (PTC), which was previously set to expire on at the end of 2010.

The act extends the 'placed-in-service' sunset date for both open-loop and closed-loop biomass electricity generation projects through 2013. To qualify for the PTC under the act, a biomass project must be placed in service on or before 31 December 2013.

This extension removes a significant portion of the uncertainty previously faced by developers and investors

in biomass projects with long-term development and construction requirements.

The act did not change the basic operation or calculation of the PTC for open-loop or closed-loop biomass projects. Therefore any qualifying closed-loop biomass project that meets the placed-in-service requirement will qualify for a credit of \$0.15 (indexed for inflation) per kilowatt hour of electricity generated and sold to an unrelated person during each year of the 10-year period beginning on the date the project is originally placed in service. Any qualifying open-loop biomass project that meets the placed-in-service requirement will qualify for a credit equal to one-half of the credit allowable for a closed-loop biomass project for the same 10-year period. For 2008, the inflation-indexed credit per kilowatt hour was \$0.021 (\$0.01 for electricity produced from open-loop biomass). The inflation-indexed rate for 2009 has not yet been released.

The act also allows the owner of a qualified biomass facility to elect to claim an investment-based tax credit

(ITC) in lieu of the PTC.

This election applies to open-loop and closed-loop facilities that are placed in service from 1 January 2009 to 31 December 2013.

The owner of a qualifying facility making such an election will be entitled to a credit equal to 30% of the cost of depreciable tangible property that is used as an integral part of the facility. The entire amount of the ITC is available in the year in which a qualifying facility is placed in service. Any unused portion of the credit can be carried back one tax year and carried forward up to 20 tax years. Unlike the PTC, the amount of the ITC allowable for an open-loop biomass facility is the same as the amount of the ITC allowable for a closed-loop biomass facility. The owner of a qualifying facility can elect to claim either the ITC or the PTC with respect to the facility, but not both. Therefore, if the owner of a qualifying facility claims the ITC for the year in which the facility is placed in service, the owner may not also claim the PTC for that year or any subsequent years. The tax basis of a

project for which the ITC is claimed must be reduced for all tax purposes by one-half of the amount of the credit, including for purposes calculating depreciation deductions and determining the tax consequences upon sale of the property.

The act also eliminates the previous ITC limitation applicable to projects receiving subsidized energy financing or tax-exempt bond financing. Under prior law, if a project received subsidized energy financing or proceeds of tax-exempt bonds, the tax basis of the project for purposes of calculating the ITC was reduced by the same ratio as the subsidised energy financing bore to the overall cost of the project. The elimination of this cut-back provides new opportunities for owners of biomass projects to obtain favorable government-supported financing without reducing the amount of available tax credits. This change could substantially increase the overall value of a project obtaining subsidised energy financing.

In addition to the election to claim the ITC rather than the PTC, the act also allows the

owners of certain facilities that qualify for the ITC (including by reason of an election to claim the ITC rather than the PTC) to elect to receive a cash grant payments from the US Treasury Department in lieu of claiming tax credits.

A project qualifies for this election if it otherwise qualifies for the ITC and it is either placed in service during, or construction is begun in, 2009 or 2010. These grants function in the same manner as the ITC for which the owner of a project otherwise would have been eligible. Thus, the amount of the grant generally is 30% of the cost of qualifying property. A grant payment is not included in the taxable income of the recipient, but the tax basis of the property is reduced by one-half of the amount of the grant, in the same fashion as the tax basis of property that qualifies for the ITC.

The Treasury Department is required to pay a grant to a qualifying project owner within 60 days of the date the project owner's application for payment is made or the date the facility is placed in service, whichever is later. The act contains a specific appropriation provision to help ensure that funds will be available to pay the grant to qualifying project owners.

The act also extends first-year bonus depreciation deductions to projects that are placed in service in 2009. Under the bonus depreciation rule, an owner of qualifying property is entitled to deduct 50% of the adjusted basis of the property in 2009. The remaining 50% of the adjusted basis of the property is depreciated over the regular tax depreciation schedule applicable to the property. Coupled with short-term MACRS depreciation deductions (e.g. five years), bonus depreciation can cause a project to generate significant tax losses in the early years that can be extremely

valuable, particularly if the owner or investor can use the losses to offset other sources of taxable income.

The extension of the PTC resolves a great deal of uncertainty regarding the financing of projects with long-term construction requirements. The changes to the PTC and the ITC made by the act, as well as the creation of Treasury Department grants, will, however, create ongoing issues regarding when a project is placed in service for tax purposes. For example, the Treasury Department grants generally only apply to qualified projects that are placed in service in 2009 and 2010, or with respect to which construction is begun in 2009 or 2010. Thus, there may still be significant pressure to place projects in service by the end of 2010 even though the PTC sunset date has been extended through 2013.

Generally speaking, a facility is placed in service for tax purposes when it is placed in a state or condition of readiness to fulfill a specifically designated function. To be considered placed in service, a facility generally need not be operating at full capacity, but must be completed and ready to operate as designed. There may also be uncertainty over exactly what it means to 'begin construction,' which is not specifically defined in the act. These issues can create significant questions with respect to projects that involve complex long-term development and construction, as well as projects that involve long-term processing of biomass before it can be used to generate electricity.

One issue that has arisen in the past and likely will continue to arise under the provisions of the act is exactly what property constitutes a 'facility' for purposes of the various tax credits and other rules. In

Notice 2008-60, 2008-30 IRB 178, the Internal Revenue Service (IRS) concluded that an open-loop biomass facility 'is a power plant consisting of all components necessary for the production of electricity from open-loop biomass (and, if applicable, other energy sources).'

The IRS concluded that a qualified open-loop biomass facility includes 'all burners and boilers... any handling and delivery equipment that supplies fuel directly to and is integrated with such burners and boilers, steam headers, turbines, generators, and all other depreciable property necessary to the production of electricity.'

The IRS concluded that a facility 'does not include (i) property used for the collection, processing, or storage of open-loop biomass before its use in the production of electricity, (ii) transformers or other property used in the transmission of electricity after its production, or (iii) ancillary site improvements, such as roadways or fencing, that are not necessary to the production of electricity.'

These standards may be somewhat difficult to interpret, depending on the specific nature of a project and all of its components. For example, if a project involves a long and detailed process of preparing biomass for use in producing electricity, some or all of the property involved in that process may not be considered part of the 'facility' for purposes of the applicable tax credits. In such a case, it may be difficult to determine whether the electricity production equipment has been placed in service, particularly if the equipment is unable to generate electricity until the processing of the biomass is completed. These issues must be carefully considered in evaluating any project intended to qualify for the various tax credits.

The changes made by the

act also place a premium on high quality financial modeling. As a general matter, good financial modeling will help accurately determine whether the owner of a project or an investor would be better off claiming the PTC or the ITC or receiving a Treasury Department grant. It will also help determine with greater accuracy whether an owner or investor will be able to use all of the tax benefits available. For example, the application of complex partnership tax accounting rules may limit the ability to allocate tax losses to an investor in a project that is financed with nonrecourse debt. All of these issues should be addressed in pre-development modeling to ensure that no surprises will arise when it comes time to prepare tax returns. The introduction of the Treasury Department grants could have a significant impact on this analysis since the grant proceeds presumably are not subject to at-risk and passive activity loss rules that can limit individual investors' ability to benefit from the PTC and the ITC.

Overall, the act creates significant new financing opportunities for biomass projects. The act also creates significant challenges, however, that will place a premium on careful advance planning.

There is a great deal about the tax provisions in this act that remain unresolved. This, in turn, makes it crucial that developers and investors alike stay abreast of developments as they occur and remain ready to react to those developments and implement appropriate adjustments, including revisions to business structures and financial models. ●

For more information:

This article was written by Kevin Pearson and John Eustermann, partners at Stoel Rives, a leading provider of legal services to developers of, and investors in, renewable energy projects throughout the world, www.stoel.com