CLIENT ALERT

Renewable Energy Federal Tax Benefits

The Legislative Saga Continues

Tax benefits available for renewable energy projects are an important incentive for developers, financial investors and sponsors of such projects. The following summarizes:

SECTION A: Federal Tax Benefits by Project Type under § 45(a) and § 48(a)[1]
SECTION B: Qualifications, Durations, Expirations and Pending Proposals
SECTION C: Structuring to Maximize Tax Benefits

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SECTION A

In this alert we will cover three significant federal tax benefits: production tax credit ("PTC"), investment tax credit ("ITC") and accelerated depreciation. The following charts illustrate, by project type, the tax benefits associated with each type of project.

Project	PTC*	Duration of Credit**	Depreciation
Biomass (Closed-Loop)	2.0 cents per kW/Hr	10 years	5 Years MACRS
Biomass (Open-Loop)	1.0 cents per kW/Hr	10 years	5 Years MACRS
Geothermal***	2.0 cents per kW/Hr	10 years	5 Years MACRS (but for electricity, only up to the electrical transmission stage)
Municipal Solid Waste / Land Fill Gas & Trash Combustion	1.0 cents per kW/Hr	10 years	7 Years MACRS
Qualified Hydropower	1.0 cents per kW/Hr	10 years	20 Years MACRS
Solar***	2.0 cents per kW/Hr	10 years	5 years MACRS
Wind	2.0 cents per kW/Hr	10 years	5 Years MACRS

* Subject to annual adjustment based on a reference to the GDP Implicit Price Deflator. These figures are based on Notice 2007-40.
** This period begins once the qualified facility is placed in service (see discussion below).
*** Geothermal and solar projects cannot utilize both the ITC and PTC.

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Project	ITC*	Expiration	Depreciation
Geothermal**	10%		(See PTC chart on previous page)
Qualified Fuel Cell	30%	12/31/08	5 Years MACRS
Qualified Microturbine	10% (not to exceed $200 for each kW of capacity)	12/31/08	5 Years MACRS
Solar**	30%	12/31/08	5 Years MACRS

* The ITC is calculated by multiplying the applicable percentage by the basis of the renewable energy property placed in service.
** Geothermal and solar projects cannot utilize both the ITC and PTC.

SECTION B

Production Tax Credit

To be eligible for the PTC, the facility must be "placed in service" before expiration of the credit. If this deadline is met, then the PTC is available to the "owner" of the facility over a period of years (the "Duration"). Currently, the Duration for PTCs is generally ten years. However, because the Duration used to be only five years, there is a question of whether upgrades, modifications or additions to a facility would cause the facility to have a new placed in service date. The general rule is that the value of the used property cannot be more than 20% of the new facility's fair market value (commonly known as the "80/20 test").

Generally, "placed in service" occurs when the property is placed in a condition or state of readiness and availability for a specifically designed function. However, decades of case law and Internal Revenue Service ("IRS") guidance has interpreted the meaning of "placed in service" in various contexts, so the facts of the transaction need to be considered when determining whether all or a portion of the facility meets this requirement by the prescribed deadline.

Generally, the PTC is available with respect to energy "produced by the taxpayer" and the taxpayer must own the facility.[2] For these purposes, partners in partnerships are treated as owners and producers.

The PTC is set to expire at the end of 2008. Therefore, to be eligible for the credit, one must place the facility in service by December 31, 2008. Several bills have been written in Congress that would extend the PTC (the proposed extensions would vary but generally would be a minimum of several years, with some proposed extensions going out as far as 2017 [solar]). In the past (e.g., 1999 and 2001), Congress has allowed the PTC to expire before renewing, retroactively.

It is likely that Congress will enact extensions, even if not prior to the year-end expirations, and that these extensions will be retroactive. Despite this likelihood, as a practical matter developers will need to attempt to place facilities in service prior to year-end and industry participants should pressure Congress to act on the extensions. This is because it is not likely that new projects will be financed on the expectation of retroactive extensions.

Investment Tax Credit

The ITC is derived from taking a percentage of the basis of the energy property placed in service during the taxable year. The amount of the ITC is either 30 percent or 10 percent. The term "energy property" includes the type of property

listed in the chart above. The taxpayer must either construct, reconstruct, erect or be the first user of the energy property.[3] The ITC is limited in part if the energy property is financed by governmentally subsidized energy financing or tax-exempt private activity bonds. Further, the ITC for qualified fuel cell property may not exceed $500 for each 0.5 kW of the property's capacity and the ITC for qualified microturbine property may not exceed $200 for each kW of capacity.

The Congressional bills relating to PTC also address the extension of the application of the ITC beyond the current expiration date of December 31, 2008. In addition to extending the expiration of the ITC, various provisions in these bills propose to increase the credit. The general consensus is that none of these bills will be passed prior to the end of 2008. Therefore it is important for active development projects to be placed in service before year-end to ensure qualification for the ITC.

SECTION C

In order to finance projects, developers and others (for example, private equity sponsors) need to maximize the tax benefits.

Tax benefits for a project have a limited duration (typically spanning over five to ten years). In order to maximize the value of the tax benefits, it is essential to match the tax benefits with taxable income. Typically, developers are in less demand for the tax benefits in the early years of the project, while some investors can gain an upside from their investment if they can fully utilize the tax benefits.

As a result, structures typically are arranged to allocate tax items (including credits) disproportionately to one party for a period of years. After this period of initial allocation, there is a "flip" so that the parties thereafter are allocated tax items in similar percentage amounts as their partner. These are often referred to as "flip partnership structures."

The IRS has issued guidelines on these types of allocations in Revenue Procedure 2007-65. Although this revenue procedure (a) is not law, (b) specifically only addresses wind projects and (c) contains partnership allocations not described in the revenue procedure that may very well pass scrutiny, as a practical matter financial investors are demanding that their transactions be structured to comply with the guidelines.[4]

CONCLUSION

Federal tax benefits have been critical to closing the financial gap faced by renewable project developers and providing a vibrant source of equity in the renewable sector notwithstanding the start/stop nature of Congressional enactments. As the industry faces another impending expiration date, the market conditions favoring the need for renewable power sources are more compelling than ever. Renewable energy market participants of all political persuasions are thus well advised in this election year to urge their Representatives to make the extension of such tax benefits a priority.

1 References to "§" and "Code" are to the Internal Revenue Code of 1986, as amended.

2 However, there are exceptions to this general rule. For example, for open-loop biomass facilities (as well as certain modified closed-loop biomass facilities), if the owner is not also the producer, then the person eligible for the credit is the lessee or operator of the facility.

3 Generally, "energy property" for these purposes does not include property if it is used predominantly in the taxpayer's trade or business of selling electricity, water, sewage, local gas or telephone services, except that this exception does not apply to qualified fuel cell or microturbine property used for furnishing or selling telephone or domestic telegraph services.

4 See, March 18, 2008 letter from the Department of Treasury (Eric Solomon) to industry participants.

New York
Seven Times Square
New York, NY 10036
+1.212.209.4800
+1.212.209.4801 [fax]

Boston
One Financial Center
Boston, MA 02111
+1.617.856.8200
+1.617.856.8201 [fax]

Washington, DC
601 Thirteenth Street NW,
Suite 600
Washington, DC 20005
+1.202.347.2222
+1.202.347.4242 [fax]

Hartford
City Place I
185 Asylum Street
Hartford, CT 06103
+1.860.509.6500
+1.860.509.6501 [fax]

Providence
121 South Main Street
Providence, RI 02903
+1.401.276.2600
+1.401.276.2601 [fax]

London
8 Clifford Street
London, W1S 2LQ
United Kingdom
+44.20.7851.6000
+44.20.7851.6100 [fax]

Dublin
Alexandra House
The Sweepstakes
Ballsbridge, Dublin 4
Ireland
+353.1.664.1738
+353.1.664.1838 [fax]

www.brownrudnick.com

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Patrick M. Cox
Phone: +1.212.209.4949
Email: pcox@brownrudnick.com

Howard L. Siegel
Phone: +1.860.509.6519
Email: hsiegel@brownrudnick.com

Madeleine M.L. Tan
Phone: +1.212.209.4805
Email: mtan@brownrudnick.com

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