

TAX CREDITS AVAILABLE TO ENERGY INVESTORS

By

Muhammad Asif*

Summery

World is facing energy crises including Pakistan, the high oil price and import of oil causes high impact on financial budget of Pakistan. Therefore, it is high time to think, implement and recognize the vast potential of renewable sources. The developed country like USA is working on Energy Tax Credit scheme like carbon Trading Credit. Pakistan should also come up and give incentives to energy investors in order face challenges of short power and improve country economy.

Therefore Energy Tax Credits could provide the necessary incentive for investors to invest in Preferred Energy. These credits, however, are not freely granted to every type of project or even every type of investor. Instead, before investing in any project with an expectation of generating an Energy Tax Credit, an investor should ensure that both the project and the investor qualify for the Energy Tax Credit by analyzing and complying with the underlying rules governing such credit. Furthermore, investors should carefully consider any applicable sunset provisions, at least until Congress extends or removes those sunset provisions

Introduction

In recognition of the vast potential of renewable energy sources, such as solar and wind, US Congress and many state governments are now offering tax incentives specifically intended to promote the generation and use of cleaner, renewable forms of energy ("Preferred Energy"). Many renewable energy projects that were previously economically unfeasible may now be profitable because of tax credits provided in the Internal Revenue Code. Tax credits are available not only for independent power producers and their investors, but also for indirect investors, such as bondholders. This article identifies and discusses several of these tax credits ("Energy Tax Credits").

Despite their obvious benefits on the U.S. economy, and their mitigating effect on the U.S. energy crisis, many Energy Tax Credits are set to expire by the end of this year. Congress has presently failed to pass an extender bill to prolong the life of these Energy Tax Credits. As a result, this article also seeks to inform readers of the vast benefits provided by Energy Tax Credits, and the colossal lost potential if Congress fails to extend those Energy Tax Credits which are subject to sunset provisions.

What are Tax Credits?

The Code provides two well-known benefits to taxpayers: deductions and credits. Deductions reduce a taxpayer's gross income in computing the taxpayer's taxable income. Unlike deductions, the more beneficial tax credits actually reduce a taxpayer's tax liability (i.e., the amount a taxpayer actually pays), on a dollar-for-dollar basis. In other words, one dollar (\$1) of a tax credit reduces a taxpayer's tax bill by the same one dollar (\$1) amount.

Types of Energy Tax Credits

Among other types of tax credits, the Code provides credits for many types of Investments in Preferred Energy. Energy Tax Credits can be categorized based on the type of Preferred Energy, whether the Preferred Energy is used by the taxpayer or generated for resale and the form of investment in such Preferred Energy. While this article only discusses certain Energy Tax Credits available to investors, the Code permits other types of Energy Tax Credits. The Energy Tax Credits discussed herein include the Following.

*Principal Chemist Deputy Managements Representative Environment KOT ADDU POWER COMPANY LTD.

- 1-Energy Credit.**
- 2-Renewable Electricity Production Credit.**
- 3-Qualifying Advanced Coal Project Credit.**
- 4-Qualifying Gasification Project Credit.**
- 5-Advanced Nuclear Power Facility Credit.**
- 6-Clean Renewable Energy Bond (“CREB”).**

Other types of Energy Tax Credits normally available to investors include the following:

- 1- Alcohol Fuels Credit,**
- 2-Enhanced Oil Recovery Credit,**
- 3-Biodiesel and Renewable Diesel Fuel Credit,**
- 4-Low Sulfur Diesel Fuel Production Credit,**
- 5-Marginal Oil and Gas Well Production Credit,**
- 6-No conventional Source Production Credit**

The rules applicable to any of the aforementioned Energy Tax Credits are very complex. Many of the Energy Tax Credits discussed herein, or some portion thereof, are subject to sunset provisions, which terminate the associated tax benefit at a particular date. Further, many investment opportunities involving Preferred Energy are designed, at least in part, with the goal of generating Energy Tax Credits or other tax benefits. As a result, the rules applicable to each Energy Tax Credit should be carefully reviewed and analyzed before an investor should participate in any investment designed to generate Energy Tax Credits. This article does not attempt to discuss each and every rule applicable to Energy under I.R.C. § 38. The Business Credit is further categorized into the Investment Credit under I.R.C. § 46. The Energy Credit, Qualifying Advanced Coal Project Credit, and the Qualifying Gasification Project Credit are all considered part of the Investment Credit under I.R.C. § 46.

Tax Credits, but merely seeks to identify certain Energy Tax Credits available to certain Taxpayers.

1-Energy Credit

I.R.C. § 48 establishes the Energy Credit for certain “energy property” placed in service by a taxpayer. The credit amount is based on a specified percentage of the basis of energy property placed in service during the taxable year. Energy property includes property that satisfies several tests related to power source and purpose, construction or original use, depreciation, and performance and quality standards. First, to qualify as energy property, the property must use particular sources of energy to generate power or use such energy. These sources include

- 1-Solar energy,**
- 2-Geothermal deposit energy,**
- 3-Energy generated from an electrochemical process, or**
- 4-Energy generated from a stationary micro turbine power plant**

Examples of permissible purposes, depending on the source of power, include generating power, heating or cooling a structure, providing solar Process heat, and illuminating the inside of a structure using fiber-optic distributed sunlight. Second, the property must be constructed, reconstructed, or erected by the taxpayer or acquired and used by the taxpayer, if such use is the original use of the property. Third, the property must be subject to depreciation or amortization. Fourth, the property must meet certain performance and quality standards in effect when the property is acquired. Finally, certain “public utility property” will not qualify as energy property for purposes of the Energy Credit. The Energy Credit is calculated by multiplying the basis of any energy property by the “energy percentage.” The energy percentage is provided in the following table.

Type of Energy Property	Percentage
Qualified Fuel Cell Property	30%
(Electrochemical-based power)	
Certain Solar-Based Energy Property	30%
All Other Energy Property	10%

A gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated Balance of plant components which convert a fuel into electricity and thermal energy. Such term also includes all secondary components located between the existing infrastructure for fuel delivery and the Existing infrastructure for power distribution, including equipment and controls for meeting relevant power Standards, such as voltage, frequency, and power factors.” Certain provisions of I.R.C. § 48 are currently set to expire at the end of years 2008 and 2009. The Energy Credit, along with other subsidiary credits of the Investment Credit, is Claimed by filing I.R.S. Form 3468 (“Investment Credit”).

2-Renewable Electricity Production Credit

The Renewable Electricity Production Credit arises from the production and sale of electricity from certain types of “qualified energy resources” by a “qualified facility. “Qualified energy resources include the following types of energy sources:

- 1. Wind,**
- 2. closed-loop biomass,**
- 3. open-loop biomass,**
- 4. Geothermal energy,**
- 5. Solar energy,**
- 6. Small irrigation power,**
- 7. Municipal solid waste, and**
- 8. Qualified hydropower production.**

Qualifying facilities generally include facilities using the above-mentioned energy sources to produce power. Such term also includes a refined coal production facility and coal produced from resources owned by or for an Indian tribe. For most qualifying facilities, the credit is available during the ten-year period beginning on the date the facility was originally placed in service, but is reduced for other types of qualifying facilities

The Renewable Electricity Production Credit is calculated by multiplying the kWh of available for power produced within the U.S. or a possession of the U.S. The credit is phased out on an inflation-adjusted basis, and is reduced for certain types of facilities phased out on an inflation-adjusted basis, and is reduced for certain types of facilities after 2003. Certain agricultural cooperatives may elect to allocate the Renewable Electricity Production Credit among its patrons. Finally, the Energy Credit is claimed, in part, by filing I.R.S. Form 8835 (“Renewable Electricity, Refined Coal, and Indian Coal Production Credit”)

3-Qualifying Advanced Coal Project Credit.

The Energy Policy Act of 200523 added an additional Energy Tax Credit under I.R.C. § 48A, providing for a Qualifying Advanced Coal Project Credit for certain investments in “qualifying advanced coal projects.” Qualifying advanced coal projects are projects that, among other characteristics, use advanced coal-based generation technology. A generation unit uses advanced coal-based generation technology when it employs integrated gasification combined cycle technology or has a specified design net heat rate and meets other emission performance standards. The Qualifying Advanced Coal Project Credit is computed by multiplying the “qualified investment” amount by an applicable percentage rate. The qualified investment amount is the basis of property placed in service during the year which is part of the qualifying advanced coal project.

Property qualifies for the credit only if it is constructed, reconstructed, or erected by the taxpayer, or acquired by the taxpayer and the original use of the property commences with the taxpayer, and subject to depreciation or amortization. The applicable percentage rate depends on the type of project giving rise to the credit. For integrated gasification combined cycle projects, the applicable percentage rate is twenty percent (20%).

For projects using any other advanced coal-based generation technologies, the applicable percentage rate is fifteen percent (15%). Further, similar to Clean Renewable Energy Bonds, qualified advanced coal projects are subject to certification by the Secretary, and the amount available for Qualifying Advanced Coal Project Credits is subject to an aggregate nation-wide maximum and a per-project maximum. The Qualifying Advanced Coal Project Credit is claimed, in part, by filing I.R.S. Form 3468 ("Investment Credit").

4-Qualifying Gasification Project Credit.

The Energy Policy Act of 2005 also added the Qualifying Gasification Project Credit under I.R.C. § 48B. This section provides a credit for certain investments in qualifying gasification projects. Qualifying gasification projects employ gasification technology, which is defined as a process that converts a solid or liquid product from certain materials into a synthetic gas comprised primarily of carbon monoxide and hydrogen. The Qualifying Gasification Project Credit is computed by multiplying the "qualified investment" amount by twenty percent (20%). Similar to Qualifying Advanced Coal Project Credit, the qualified investment amount here is the basis of property placed in service during the year which is part of the qualifying gasification project. Property qualifies for the credit only if it is constructed, reconstructed, or erected by the taxpayer, or acquired by the taxpayer and the original use of the property commences with the taxpayer, and subject to depreciation or amortization. As with the Qualifying Advanced Coal Project Credit, the Secretary must grant approval for the proposed project before the project will generate a Qualifying Gasification Project Credit. The Qualifying Gasification Project Credit is claimed, in part, by filing I.R.S. Form 3468 ("Investment Credit").

5-Advanced Nuclear Power Facility Credit.

Another Energy Tax Credit established by the Energy Policy Act of 2005 is the Advanced Nuclear Power Facility Credit under I.R.C. § 45J.24 this provision provides a credit for the production and sale of electricity generated by an advanced nuclear power facility for a period of eight years from the date the facility was placed in service. An advanced nuclear power facility is a facility that is owned by the taxpayer, uses nuclear energy to produce electricity, and is placed in service before Jan. 1, 2021. The reactor design for the facility must have been approved after Dec. 31, 1993 by the Nuclear Regulatory Commission. The credit is calculated by multiplying the kWh of electricity produced and sold during the taxable year by 1.8 cents (\$.018). The credit is, however, limited based on a national maximum of kWh allocated to the advanced nuclear power facility by the Secretary. The credit is further limited by an annual limitation and is subject to an inflation-adjusted phase out.

6-Clean Renewable Energy Bond Credit

The last Energy Tax Credit selected for discussion in this article involves the Clean Renewable Energy Bond Credit under I.R.C. § 54. This credit was also added by the Energy Policy Act of 2005.²⁵ Unlike the other Energy Tax Credits discussed herein, the Clean Renewable Energy Bond Credit is available to indirect investors (e.g., bondholders) instead of direct participants. Clean Renewable Energy Bonds are also distinguishable from other types of tax-beneficial bonds in that they may be issued by non-governmental entities (e.g., certain electric cooperatives). I.R.C. § 54 provides holders of Clean Renewable Energy Bonds with a tax credit, which represents a hypothetical amount of interest payable on a quarterly basis. The amount of the credit is calculated by multiplying a "credit rate" established by the Secretary and the Outstanding face amount on the bond. Clean Renewable Energy Bonds include bonds which are, in addition to other requirements, issued by a "qualified issuer" in which ninety-five percent

(95%) or more of the proceeds are used for “qualified projects” of a “qualified borrower.” Qualified projects include projects related to the following electricity-producing facilities:

- 1-Wind Power Facility,**
- 2-Closed-Loop Biomass Facility,**
- 3-Open-Loop Biomass Facility,**
- 4-Geothermal or Solar Energy Facility,**
- 5-Small Irrigation Power Facility,**
- 6-Landfill Gas Facility,**
- 7-Trash Combustion Facility,**
- 8-Refined Coal Production Facility,**
- 9-Qualified Hydropower Facility.**

There are three primary players in the context of Clean Renewable Energy Bonds: the holder, the qualified issuer, and the qualified borrower. The holder is the taxpayer which has purchased the Clean Renewable Energy Bond and is seeking to claim the related credit. A qualified issuer is either the lender of the proceeds or the qualified borrower itself. In any event, the qualified issuer is a cooperative lender which is owned by, or has outstanding loans to, 100 or more cooperative electric companies (as such term is defined in this Code section); a cooperative electric company; or a governmental Body. Qualified borrowers include certain electric cooperatives and governmental bodies. Clean Renewable Energy Bonds are certified for approval by the Secretary by allocating a nation-wide maximum. On Feb. 8, 2008, the Service announced that it approved 312 projects financed through Clean Renewable Energy Bonds. Currently; the Clean Renewable Energy Bond Credit is set to expire in Dec. 31, 2008, but the sunset provision is being considered for extension. The Clean Renewable Energy Bond Credit is Claimed, in part, by filing I.R.S. Form 8912 (“Credit for Clean Renewable Energy and Gulf Tax Credit Bonds”).

7-Other Energy Tax Credits.

A few other Energy Tax Credits not discussed in detail herein, nonetheless, deserve a short mention.

1-The Enhanced Oil Recovery Credit under I.R.C. § 43 relates to projects involving one or more tertiary recovery methods which result in more effective crude oil Recovery.

2-The Marginal Oil and Gas Well Production Credit under I.R.C. § 45I relates to projects involving qualified crude oil production and qualified natural gas Production from a qualified marginal well.

3-The No conventional Source Production Credit under I.R.C. § 45K provides a credit for energy sold by the taxpayer and which was produced by certain “qualified fuels,” including oil produced from shale and tar sands; gas produced from geo pressured brine, Devonian shale, coal seams, or tight Formation or biomass; and liquid, gaseous, or solid synthetic fuels produced From coal (including lignite), including such fuels when used as feed stocks.

8-Conclusion

Energy Tax Credits could provide the necessary incentive for investors to invest in Preferred Energy. These credits, however, are not freely granted to every type of project or even every type of investor. Instead, before investing in any project with an expectation of generating an Energy Tax Credit, an investor should ensure that both the project and the investor qualify for the Energy Tax Credit by analyzing and complying with the underlying rules governing such credit. Furthermore, investors should carefully consider any applicable sunset provisions, at least until Congress extends or removes those sunset provisions.