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Clients&FriendsMemo

Energy Tax Provisions in the Obama Administration's Fiscal Year 2012 Budget

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I. Introduction

On Monday, the Treasury Department released the Obama Administration's Fiscal Year 2012 Revenue Proposals (the "**Greenbook**"), which includes several significant energy-related tax proposals.[1] The proposals are all substantially similar to the energy-related tax proposals in last year's Greenbook, except for a new proposal to provide a tax credit in lieu of a deduction for energy-efficient commercial buildings, which is discussed below in Part III.

In short, the Greenbook's proposals would, if enacted:

- Repeal a number of energy-related tax preferences, including tax credits and accelerated deductions.
- More than triple the aggregate amount of "qualifying advanced energy project" tax credits (from $2.3 billion to $7.3 billion) that the IRS may award for property used to re-equip, expand, or establish certain manufacturing facilities for the production of renewable and advanced energy property. Taxpayers would be able to apply for tax credits up to 30% of their basis in qualifying property during the two-year period following enactment.
- Provide a tax credit in lieu of the deduction that is currently available for certain costs relating to the retrofitting of commercial buildings to increase their energy efficiency.

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1 For a summary of some of the Greenbook's significant proposals that are not directly related to the energy industry, please see our Clients & Friends Memo, "Tax Proposals in the Obama Administration's Fiscal Year 2012 Revenue Budget," available at http://www.cadwalader.com/assets/client_friend/021711TaxProposalsin2012RevenueBudget.pdf.

This memorandum discusses only the Greenbook proposals. There are a number of recently enacted energy-related tax incentives. For example, taxpayers may benefit from "bonus" depreciation for qualifying energy property acquired and placed into service before 2013.

- Extend the availability of the cash grant in lieu of an investment tax credit with respect to certain renewable energy projects whose construction begins in 2012.[2]
- Reinstate the pre-1996 "Superfund" excise tax on crude oil, certain other petroleum products, and certain hazardous chemicals.

The balance of this memorandum discusses the Greenbook's key energy proposals.

II. Eliminate Fossil Fuel Tax Preferences

The Greenbook reproposes last year's proposal to eliminate several tax preferences relating to oil, gas, and coal. The following is a summary of the significant fossil fuel preferences that the Greenbook proposes to eliminate.

- **Repeal the enhanced oil recovery credit.** The Greenbook proposes to repeal the 15% tax credit for certain costs attributable to a "qualified enhanced oil recovery project."[3] (This credit has never been effective because its availability is based on energy prices and energy prices have exceeded the applicable threshold for the years in which the credit has been in place.)
- **Repeal the credit for oil and gas produced from marginal wells.** The Greenbook proposes to repeal the existing tax credit equal to $3.00 per barrel of domestic crude oil or $0.50 per 1,000 cubic feet of natural gas produced from qualifying domestic wells.[4] (This credit has never been effective because its availability is based on energy prices and energy prices have exceeded the applicable threshold for the years in which the credit has been in place.)
- **Repeal the current deduction for intangible drilling costs.** The Greenbook would generally deny holders of working interests in domestic oil or gas properties current deductions for wages, the cost of fuel, repairs, hauling, supplies that do not have a salvage value, and certain other costs that are incident to and necessary for the preparation or drilling of wells. Current law generally permits these holders to either deduct these costs in the first year in which they are

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2 The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this program through 2011. The Greenbook would extend it another year.

3 In general, a qualified enhanced oil recovery project is a project in the United States involving the application of at least one tertiary recovery method that results in more than an insignificant increase in the amount of crude oil that will ultimately be recovered. Section 43. Tertiary recovery generally involves the injection of gases into a well to stimulate oil flow.

All references to section numbers are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

4 Section 45I.

incurred, or amortize them over five years.[5] The proposal would require any of these costs paid or incurred after 2011 to be capitalized.

- **Repeal the current deduction for the costs of tertiary injectants.** The Greenbook proposes to repeal the currently available deduction for the costs of certain tertiary injectants that are used as part of a tertiary recovery method to increase the recovery of crude oil.[6] The proposal would require any of these costs paid or incurred after 2011 to be capitalized.

- **Repeal the current deduction for exploration and development costs.** The Greenbook proposes to repeal the currently available deduction for the costs of ascertaining the existence, location, extent, or quality of a domestic ore or other mineral deposit (including coal or other hard mineral fossil fuel deposits), and of developing mines to exploit these deposits.[7] The proposal would require any of these costs paid or incurred after 2011 to be capitalized.

- **Repeal the percentage depletion method for oil and gas wells and hard-mineral fossil fuel mines.** The Greenbook proposes to disallow the percentage depletion method with respect to oil and natural gas wells and hard-mineral fossil fuel deposits (e.g., coal and certain lignite and oil shale mines), and would require taxpayers to use the cost depletion method with respect to these properties.[8] (Under current law, taxpayers may choose between the two methods.[9]) The proposal would be effective for taxable years beginning after 2011.

- **Require seven-year amortization for geological and geophysical expenditures of independent producers.** The Greenbook proposes to require seven-year

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[5] Section 59(e); section 263(c); Treasury regulations section 1.612-4. Current law permits "integrated oil companies" (generally, crude oil producers that carry on substantial retailing or refining operations) to deduct only up to 70% of these costs in the year in which they are incurred, but allows five-year amortization of the remaining costs. Section 291(b). The Greenbook also proposes to repeal this provision.

[6] Section 193. Limitations apply to the deductibility of tertiary injectants that contain more than an insignificant amount of recoverable natural gas or crude oil. Treasury regulations section 1.193-1(c).

[7] Section 616(a); section 617(a). Current law limits the election to 70% of a corporation's mining exploration and development costs, but allows five-year amortization of the remaining costs. Section 291(b). The Greenbook also proposes to repeal this provision.

[8] In general, percentage depletion permits owners of interests in hard-mineral fossil fuel deposits, and certain independent producers and royalty owners of interests in oil or gas wells, to deduct a specified percentage of their gross income from the property each year, even after their aggregate deductions exceed their investment in the property. Section 613. Cost depletion generally permits an annual cost recovery deduction in proportion to the exhaustion of a property's recoverable reserves and is limited, in the aggregate, to the taxpayer's basis in the property. Section 611; section 612.

[9] Section 613. However, current law reduces the available percentage depletion deduction for corporations with respect to iron ore and coal (including lignite) after a property's basis is exhausted, and severely limits the use of percentage depletion with respect to oil or gas wells. Section 291(a)(2); section613A.

amortization of all geological and geophysical expenditures paid or incurred in connection with the domestic exploration for, or development of, oil or gas. Current law generally requires seven-year amortization only for "major integrated oil companies," and permits two-year amortization for other producers.[10] The proposal would be effective for geological and geophysical expenditures paid or incurred after 2011.

- **Repeal the domestic manufacturing deduction for oil and gas companies.** The Greenbook proposes to repeal the domestic production activities deduction for producers, refiners, processors, transporters and distributors of oil, natural gas, hard-mineral fossil fuels (e.g., coal and certain lignite and oil shale), and "primary products" of these fuels. Very generally, current law permits a deduction of 9% (or 6% for oil and gas activities) of the lesser of (i) gross receipts derived from the disposition of these fossil fuels, reduced by the cost of goods sold and other expenses allocable to the receipts and (ii) taxable income, but not in excess of 50% of W-2 wages paid.[11] The proposal would be effective for taxable years beginning after 2011.

- **Subject working interests in oil and gas properties to the passive activity loss rules.** The Greenbook proposes to repeal the exception to the "passive activity loss rules" that currently applies to any working or operating mineral interest in an oil or natural gas property that a taxpayer holds either directly or through an entity that does not limit the taxpayer's liability.[12] Under the proposal, the passive activity loss rules would apply to prevent passive holders of oil or gas properties from using losses generated by these properties to offset gains from non-passive activities until the holders dispose of their interests in the oil or gas properties. The proposal would be effective for taxable years beginning after 2011.

- **Tax coal and lignite royalties as ordinary income.** The Greenbook proposes to tax any gain or loss from the sale of coal (including lignite) as ordinary income or loss. Under current law, this gain or loss is generally treated as long-term capital gain or loss to a domestic coal mine lessor that is a passive recipient of royalties under the lease and owns the coal for more than one year before the coal is

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[10] Section 167(h). In general, a major integrated oil company is a crude oil producer that (i) has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, (ii) had gross receipts of more than $1 billion for its last taxable year ending in 2005, and (iii) has significant ownership interests in refineries whose aggregate average daily crude oil input volume for the taxable year exceeds 75,000 barrels.

[11] Section 199.

[12] Section 469(c)(3).

mined.[13] The proposal would be effective for royalties realized in taxable years beginning after 2011.

III. Expand the Qualifying Advanced Energy Projects Credit Program

The Greenbook reproposes last year's proposal to expand the "qualifying advanced energy project credit program" by increasing the aggregate amount of tax credits that the IRS can award from $2.3 billion to $7.3 billion.[14] Under this program, the IRS may award credits equal to 30% of a taxpayer's basis in certain property that is used in a project that re-equips, expands, or establishes a qualifying manufacturing facility for the production of certain renewable and advanced energy property.[15]

Under the proposal, applications for credits could be made during the two-year period following enactment. In addition, the proposal would modify the existing rules to permit taxpayers to apply for credits with respect to only a portion of the applicable property's cost (rather than the property's entire cost), and the IRS could take into account the fact that a taxpayer is requesting only a partial credit in determining whether to allocate credits to the project.

IV. Credit in Lieu of Deduction for Energy-Efficient Commercial Buildings

The Greenbook proposes to provide taxpayers with a tax credit in lieu of a deduction for certain costs associated with retrofitting commercial buildings to increase their energy efficiency.

Under current law, a taxpayer is generally entitled to expense the cost of any depreciable property installed before 2014 as part of a building's heating, cooling, ventilation, hot water or interior lighting system, or the building envelope, if the installation is made pursuant to a plan to increase the building's energy efficiency by 50% in accordance with IRS guidance.[16] The deduction is

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13 Section 631(c); section 1231.

14 According to the Greenbook, the current $2.3 billion cap on the amount of credits that the IRS can approve resulted in the funding of less than one-third of the technically acceptable applications that the IRS received.

15 Section 48C; IRS Notice 2009-72, 2009-37 I.R.B. 325 (August 13, 2009) (establishing the program and describing the IRS's credit allocation guidelines).

A qualifying manufacturing facility must produce: (i) property designed to produce energy from renewable resources; (ii) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (iii) electric grids to support the transmission or storage of intermittent sources of renewable energy; (iv) property designed to capture and sequester carbon dioxide emissions; (v) property designed to refine or blend renewable fuels or to produce energy conservation technologies; (vi) qualified plug-in electric drive motor vehicles, qualified plug-in electric vehicles, or components thereof; or (vii) other advanced energy property designated by the Treasury and designed to reduce greenhouse gas emissions. Section 48C(c)(1)(A)(i).

16 Section 179D(c); Notice 2006-52, 2006-1 C.B. 1175 (June 2, 2006) and Notice 2008-40, 2008-14 I.R.B. 725 (March 11, 2008).

subject to a cap of $1.80 per square foot of the building. In addition, a current deduction of up to $0.60 per square foot is permitted for the cost of certain property that does not increase a building's overall energy efficiency by 50% but satisfies energy savings targets established by the IRS in published guidance.[17]

The Greenbook proposes to replace the current deductions with a tax credit of up to $1.80 per square foot for the cost of property that increases a building's energy efficiency by at least 50%, $0.90 per square foot for property that increases a building's energy efficiency by at least 30%, and $0.60 per square foot for property that increases a building's energy efficiency by at least 20%, and would also treat certain property as satisfying the 50%, 30%, or 20% energy savings requirements if the property satisfies certain standards based on building types and climate zones.[18] In addition, the proposal would provide special rules for REITs and their shareholders.

V. Extend the Section 1603 Renewable Energy Grant Program

The Greenbook proposes to extend through the end of 2012 the cash grant that is available in lieu of an investment tax credit with respect to the construction of certain renewable energy projects. The cash grant program was introduced under section 1603 of the American Recovery and Reinvestment Act of 2009 and, if not extended, will expire at the end of 2011.[19]

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[17] Section 179D(d)(1).

[18] By permitting taxpayers a credit in lieu of a deduction, the proposal could potentially nearly triple the benefit available to a taxpayer in the current highest income tax bracket of 35%. For example, for a taxpayer in the 35% income tax bracket, a deduction of $1.80 is worth only $0.63, whereas a tax credit of $1.80 is potentially worth $1.80. The proposal does not specify whether the tax credit would be a "refundable" credit (in which case taxpayers would receive a cash refund equal to the excess of the amount of the credit to which they are entitled over the income available to be offset by the credit). Several bills introduced in Congress's last session proposed to expand the existing deduction's application and increase its amount, but did not propose to restructure the deduction as a tax credit.

[19] The cash grant is in lieu of a tax credit for 10% or 30% of the cost of qualifying property if construction of the property begins in 2009, 2010, or 2011. Section 48.

The 30% credit generally applies to qualifying (i) fuel cell power plants with a nameplate capacity of at least 0.5 kilowatts of electricity using an electrochemical process and at least a 30% electricity-only generation efficiency, (ii) equipment that uses solar energy to generate electricity or to heat, cool, or illuminate the interior of a structure, and (iii) property that uses a wind turbine with a nameplate capacity of not more than 100 kilowatts to generate electricity. Section 48(a)(2)(A)(i). The 10% credit generally applies to qualifying (i) equipment used to produce, distribute, or use energy derived from a geothermal deposit, (ii) microturbine plants with a nameplate capacity of less than 2,000 kilowatts and at least a 26% electricity-only generation efficiency, (iii) property that uses the same energy source for the simultaneous or sequential generation of electrical or mechanical shaft power and thermal energy, and (iv) equipment that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure. Section 48(a)(2)(A)(ii).

VI. Reinstate Superfund Taxes

The Greenbook proposes to reinstate pre-1996 "Superfund" excise taxes. In general, the excise taxes would consist of (i) a $0.097-per-barrel excise tax imposed on crude oil received by certain domestic exporters or refiners, and on certain imported petroleum products,[20] and (ii) a $0.22- to $4.87-per-ton excise tax on certain hazardous chemicals sold or used by manufacturers, producers, or importers, and on imported substances whose manufacture or production involved the use of these chemicals.[21] The proposal would be effective for taxable years beginning after 2011 and before 2022.

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If you have any questions regarding this memorandum, please contact any member of the Cadwalader Tax Department.

[20] Section 4671; section 4611.

[21] Section 4671; section 4661; section 4671. The Greenbook would also reinstate the Superfund environmental income tax which, very generally, would be imposed at the rate of 0.12% on the amount by which a corporation's alternative minimum taxable income, determined without regard to any deduction for this Superfund income tax or for alternative tax net operating losses, exceeds $2 million. Section 4671; section 59A.