Clients&FriendsMemo

Energy Tax Provisions in the American Taxpayer Relief Act of 2012

January 15, 2013

I. Introduction

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (the "**Act**"), which averted the "fiscal cliff."[1] The Act contains several significant energy-related tax provisions. In short, the Act:

- Extends through the end of 2013 the production and investment tax credits for wind facilities,[2]
- Allows energy producers to claim production and investment tax credits if they "begin construction" on certain energy facilities before 2014, whether or not the facilities are "placed in service" before 2014 (as had been required under prior law),
- Extends the 50% first-year bonus depreciation deduction through the end of 2013 (and through the end of 2014 for certain "longer production period property"),
- Extends through the end of 2013 the producer tax credit for cellulosic biofuel, and expands the definition of cellulosic biofuel to include algae-based fuels,[3]
- Extends through the end of 2013 the $1.00 per gallon tax credit for biodiesel and renewable diesel derived from biomass and the $0.10 per gallon tax credit for agri-biodiesel produced by certain small producers,[4]

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[1] We discussed the Act generally in a Clients & Friends Memo available at http://www.cadwalader.com/assets/client_friend/010713TheAmericanTaxpayerReliefActof2012.pdf.

[2] The production and investment tax credits are discussed in greater detail in Part II of this memorandum.

[3] The credit, which was scheduled to expire at the end of 2012, is equal to the number of gallons of cellulosic biofuel produced, multiplied by $1.01 for biofuel other than alcohol, $0.41 for biofuel that is alcohol (other than ethanol), or $0.31 for biofuel that is ethanol. See section 40(b)(6).

All references to section numbers are to the Internal Revenue Code of 1986, as amended (the "**Code**"), except where the context otherwise provides.

[4] See section 40A. These credits, which expired at the end of 2011, generally are available to producers that use or sell biodiesel or renewable diesel as fuel during the taxable year. The Act makes the credits available retroactively for 2012, and extends their availability through 2013.

- Extends through the end of 2013 the $0.50 per gallon excise tax credits and outlay payments for alternative fuels and the $1.00 per gallon excise tax credits and outlay payments for biodiesel mixtures,[5]
- Reinstates and extends through the end of 2013 the deferral of gain on the sale of transmission property by vertically integrated electric utilities to FERC-approved independent transmission companies,[6] and
- Reinstates the research tax credit and extends the credit through the end of 2013.[7]

The Act contains several other energy-related incentives, including the extension of tax credits for certain energy-efficient home improvements,[8] alternative fuel refueling property,[9] energy-efficient homes,[10] and energy-efficient appliances,[11] and the expansion of the tax credit for plug-in electric vehicles to electric motorbikes.[12] The Act does not renew the cash grant program under section 1603 of the American Recovery and Reinvestment Act of 2009, which permitted taxpayers to elect to receive cash in lieu of an investment tax credit with respect to the construction of certain renewable energy projects if the construction began in 2009, 2010, or 2011. The Act also does not extend the ability of taxpayers to use percentage depletion in excess of income with respect to oil and gas wells; as a result, beginning in 2013, percentage depletion for oil and gas wells will be limited to the amount of the taxpayer's income from the property.

Part II of this memorandum discusses the Act's expansion of the production and investment tax credits. Part III discusses the Act's extension of bonus depreciation.

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5 The incentives, which expired at the end of 2011, generally are available to offset excise taxes imposed under sections 4041 and 4081 on the sale of liquid fuels derived from biomass, compressed or liquefied biogas, compressed or liquefied natural gas, liquefied petroleum gas, and other alternative fuels. See sections 6426 and 6427. The Act makes the incentives available retroactively for 2012, and extends their availability through 2013. The Act does not extend the incentives for "black liquor," which is liquid fuel derived from a pulp or paper manufacturing process, or for liquefied hydrogen, for which the incentives are available through 2014.

6 Under section 451(i), the gain generally must be included in income ratably over eight years.

7 See section 41. This credit, which expired at the end of 2011, generally is equal to 20% of the excess of current year research expenditures over a specified "base amount." Alternatively, taxpayers can elect a credit equal to 14% of the excess of current year research expenditures over 50% of the average annual research expenditures in the three previous tax years. The Act makes the credit available retroactively for 2012, and extends its availability through 2013.

8 See section 25C.

9 See section 30C.

10 See section 45L.

11 See section 45M.

12 See section 30D.

II. Production and Investment Tax Credits

There are two alternative types of tax credits available to energy producers—"production" tax credits and "investment" tax credits.[13] Very generally, production tax credits are measured by the amount of energy produced at a facility,[14] whereas investment tax credits are equal to 30% (or 10%, in some cases) of the cost of the facility.[15] Production and investment tax credits generally are available for the following types of facilities:

- Wind,[16]
- Closed-loop biomass,[17]
- Open-loop biomass,[18]
- Geothermal,[19]
- Landfill gas or trash,[20]
- Hydropower,[21] and
- Marine and hydrokinetic.[22]

Before the Act, the tax credits were available only for wind facilities placed into service before 2013, and for other energy facilities placed into service before 2014. The Act extends the tax

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13 Production tax credits are available under section 45. Investment tax credits are available under section 48.

14 In 2012, the production tax credit for wind, closed-loop biomass, and geothermal facilities was $0.022 per kilowatt hour, and the production tax credit for open-loop biomass, landfill gas, trash, hydropower, and marine and hydrokinetic facilities was $0.011 per kilowatt hour. IRS Notice 2012-35, 2012-21 I.R.B. 937. The tax credit is indexed for inflation.

15 If a taxpayer elects the investment tax credit, the basis of the property is reduced by 50% of the credit. Section 50(c). Moreover, all or a portion of the credit is recaptured if the property is disposed of within five years. Section 50(a)(1).

16 Section 45(c)(1), (d)(1).

17 A closed-loop biomass facility uses organic material to produce electricity. Section 45(c)(2), (d)(2).

18 An open-loop biomass facility uses agricultural livestock manure and litter, certain mill and harvesting waste material, and certain other crop by-products or residues to produce electricity. Section 45(c)(3), (d)(3).

19 A geothermal energy facility uses energy derived from a geothermal deposit to produce electricity. Section 45(c)(4), (d)(4).

20 A landfill gas facility uses gas from the natural biological breakdown of municipal solid waste to produce electricity. Section 45(d)(6). A trash facility otherwise uses municipal solid waste to produce electricity. Section 45(d)(7).

21 A hydropower facility uses dams to produce hydropower. Section 45(c)(8), (d)(8).

22 A marine and hydrokinetic facility uses waves, tides, and currents to produce electricity. Section 45(c)(10), (d)(11).

A 30% investment tax credit also is available for solar energy facilities placed into service before 2017, and a 10% investment tax credit is available for solar energy facilities placed into service thereafter. A production tax credit is not available for qualified solar energy facilities placed into service after 2005. The Act does not change the availability of the tax credits for solar energy facilities.

credits to any energy facility whose construction begins before 2014, whether or not the facility is placed into service before 2014.[23]

III. Extension of Bonus Depreciation

The Act extends "bonus depreciation" under section 168(k). Very generally, under section 168(k), a taxpayer can take a first-year bonus depreciation deduction equal to 50% of the cost of any depreciable property that the taxpayer puts into service that year if the taxpayer is the first user of the property and the property has a recovery period of 20 years or less.[24] Section 168(k) expired at the end of 2012 (and was scheduled to expire at the end of 2013 for certain "longer production period property" with a recovery period of 10 years or more and an estimated production period of more than one year). The Act reinstates section 168(k) and extends it through 2013 (and through 2014 for certain longer production period property). Accordingly, energy producers that place facilities into service in 2013 year may immediately expense 50% of the cost of the facilities.[25]

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If you have any questions about the foregoing, please contact any member of the Cadwalader Tax Department or the Cadwalader Energy & Commodities Department.

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[23] It is not clear how the IRS will interpret the "begins construction" requirement. For example, the IRS may adopt a rule similar to the rule that applied to taxpayers requesting cash grants in lieu of tax credits under section 1603 of the American Recovery and Reinvestment Act of 2009, which generally treated a taxpayer as having begun construction on an energy facility when the taxpayer began "physical work of a significant nature," or otherwise incurred at least 5% of the project's total cost. The extent to which the tax credits will be available to taxpayers that purchase a project after construction has begun, and continue construction on the project, also is not clear.

[24] Bonus depreciation also applies to certain water utility property, which has a recovery period of 25 years.

[25] The Act also extends bonus depreciation under section 168(l) through 2013 for certain cellulosic biofuel plant property, to the extent the property is not otherwise entitled to bonus depreciation under section 168(k), and expands the definition of cellulosic biofuel plant property to include algae-based fuel.