McDermott Will & Emery

On the Subject

Energy & Commodities Advisory

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President Obama's budget proposal reveals the administration's agenda and priorities with respect to energy tax issues.

Key Energy-Related Tax Provisions in the 2011 Budget Proposal

On February 1, 2010, the Obama administration introduced its 2011 budget proposal (Proposal), which called for approximately $170 billion in additional stimulus measures, including more than $80 billion of tax cuts. The Proposal is significant because it reveals President Obama’s agenda and priorities for the coming year. Among the Proposal’s measures were several tax provisions of interest to energy companies and investors in energy companies. The following is a summary of the key energy tax provisions in the Proposal.

Provide Additional Tax Credits for Investment in Eligible Property Used in a Qualified Advanced Energy Manufacturing Project

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provided a 30 percent tax credit for investments in eligible property used in a qualifying advanced energy project. A qualifying advanced energy project is a project that re-equips, expands or establishes a manufacturing facility for the production of the following:

- Property designed to produce energy from renewable resources
- Fuel cells, microturbines or an energy storage system for use with electric or hybrid-electric vehicles
- Electric grids to support the transmission, including storage, of intermittent sources of renewable energy
- Property designed to capture and sequester carbon dioxide emissions
- Property designed to refine or blend renewable fuels or to produce energy conservation technologies
- Electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles
- Other advanced energy property designed to reduce greenhouse gas emissions

The aggregate amount of credits were capped at $2.3 billion and were to be distributed through a program administered by the U.S. Treasury and the Department of Energy. For more information, see McDermott’s On the Subject “Applications Now Accepted for Advanced Energy Project Tax Credits.”

However, the $2.3 billion cap resulted in the funding of less than one-third of the technically acceptable applications that were received. Thus, the Proposal would provide for an additional $5 billion in qualifying advanced energy project credits.

In addition to increasing the available credit amount, the Proposal would modify existing guidance requiring taxpayers to apply for the credit with respect to their entire qualified investment, such that taxpayers may now apply for a credit with respect to only part of their qualified investment.

Applications for the additional credits will be made during the two-year period beginning on the date on which the additional authorization is enacted. As under the current credit procedures, applicants that are allocated the additional credits must provide evidence that the requirements of the certification have been met within one year of the date of acceptance of the application and must place the property in service within three years from the date of the issuance of the certification.

Given the demand for this credit over the past year, companies with potential qualified advanced energy projects in the works should be prepared to submit their applications quickly if and when the expanded credit becomes available.

Extend Temporary Bonus Depreciation for Certain Property

The Recovery Act provided for an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualifying property acquired after calendar year 2007 and before calendar year 2010, and placed in service in calendar year 2009 (or through 2010 for certain longer recovery period property and transportation property). For more information, see McDermott's On the Subject "Energy Tax Provisions Included in American Recovery and Reinvestment Act of 2009." In addition, the Recovery Act provided that corporations otherwise eligible for additional first-year depreciation could elect to claim additional research or alternative minimum tax (AMT) tax credits in lieu of the additional first-year depreciation deduction.

The Proposal extends, for an additional year, the additional first-year depreciation deduction and the election to claim additional research or AMT tax credits in lieu of this deduction. The extension would apply to qualifying property acquired after calendar year 2007 and before calendar year 2011, and placed in service in calendar year 2010 (or through 2011 for certain longer-lived and transportation property).

The additional first-year depreciation deduction has proved to be a significant benefit to renewable energy projects, such as solar and wind projects. Although a retroactive extension of the additional first-year depreciation is welcome, the timing of the extension will be critical with respect to stimulating any renewable projects this year.

Modify Cellulosic Biofuel Producer Credit

The Internal Revenue Code currently provides an income tax credit for cellulosic biofuel of $1.01 per gallon produced by the taxpayer. Under the current credit provisions, liquid byproducts derived from the processing of paper or pulp (known as black liquor) could qualify as credit eligible cellulosic biofuel. The Proposal states that allowing this credit to black liquor producers will result in substantial revenue losses to the government and a windfall to the paper industry.

The administration, therefore, proposes to exclude from the definition of cellulosic biofuel any fuels that are more than 4 percent (by weight) water or sediment in any combination, or that have an ash content of more than 1 percent (by weight). The change would be effective on the date of enactment and would effectively exclude black liquor from the credit.

Extend and Modify the New Markets Tax Credit

The new markets tax credit (NMTC) is a 39 percent credit for qualified equity investments made in qualified community development entities that are held for a period of seven years. The NMTC expired at the end of 2009.

The Proposal would extend the NMTC through 2011, with an allocation amount of $5 billion for each of 2010 and 2011. It would also make additional improvements to the NMTC, including permitting the NMTC to offset a taxpayer's AMT liability.

Make Research and Experimentation Tax Credit Permanent

A tax credit of 20 percent is provided for qualified research and experimentation expenditures above a base amount. The base amount is generally computed by looking at the ratio of the taxpayer's research expenditures to its gross receipts for past periods. An alternative simplified credit of 14 percent above a base amount is also provided. These tax credits, which expired with respect to expenditures paid or incurred in taxable years beginning after December 31, 2009, are proposed to be permanently extended, effective as of January 1, 2010.

Codify "Economic Substance" Doctrine

The Proposal would create a new provision in the Internal Revenue Code clarifying that a transaction must have both objective economic substance and a business purpose to satisfy the judicial economic substance doctrine. Courts have diverged in the application of this doctrine by sometimes requiring both economic substance and business purposes and sometimes requiring only one of the two.

The codification of the economic substance doctrine would also come with increased penalties for understatements of tax for transactions lacking economic substance. A 30 percent penalty would now be imposed on such transactions, as opposed to the current 20 percent penalty attributable to understatements of tax. The penalty would be reduced to 20 percent for transactions that are adequately disclosed on the applicable tax return or in a statement attached to the return. In addition, deductions for interest attributable to an understatement of tax arising from the application of the economic substance doctrine would be denied under the Proposal. These changes would be effective for transactions entered into after the date of enactment.

Eliminate Fossil Fuel Tax Preferences

The Internal Revenue Code provides a number of credits and deductions that are targeted towards certain oil, gas and coal activities. President Obama agreed at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels; thus, the administration has advocated for the repeal of a number of tax preferences available for fossil fuels in the Proposal.

The following tax preferences available for oil and gas activities are proposed to be repealed beginning in 2011:

- The enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project
- The credit for oil and gas produced from marginal wells
- The expensing of intangible drilling costs
- The deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method
- The exception to passive loss limitations provided to working interests in oil and natural gas properties
- The use of percentage depletion with respect to oil and gas wells
- The ability to claim the domestic manufacturing deduction against income derived from the production of oil and gas
- Two-year amortization of independent producers' geological and geophysical expenditures, instead allowing amortization over the same seven-year period as for integrated oil and gas producers

In addition, the following tax preferences available for coal activities are also proposed to be repealed beginning in 2011:

- Expensing of exploration and development costs
- Percentage depletion for hard mineral fossil fuels
- Capital gains treatment for royalties
- The ability to claim the domestic manufacturing deduction against income derived from the production of coal and other hard mineral fossil fuels.

For more information, please contact your regular McDermott lawyer, or:

Madeline M. Chiampou: +1 212 547 5643 mchiampou@mwe.com
Caroline Hong Ngo: +1 202 756 8359 cngo@mwe.com
Martha Groves Pugh: +1 202 756 8368 mpugh@mwe.com
Philip Tingle: +1 305 347 6536 ptingle@mwe.com

For more information about McDermott Will & Emery visit: www.mwe.com