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VIA ELECTRONIC/REGULAR MAIL

Ms. Ellen Neubauer
United States Department of Treasury
1500 Pennsylvania Avenue
Washington, DC 20220-0002

Re: Request for additional guidance regarding qualified facilities
Our File No. XXXXXX

Dear Ms. Neubauer:

Lane Powell PC represents developers of projects that involve the recovery of combustible gas from the biodegradation of municipal solid waste ("Biogas") for the purpose of producing electricity. In the course of developing Biogas projects, the developers must make numerous business decisions relating to the geographical location and ownership of various large pieces of equipment, including generating equipment. Each project will qualify for the investment tax credit ("ITC") under section 48[1] and the grant under ARRA section 1603 (the "1603 Grant") if the various components of the project are owned by a single person and located at a single site. However, locating all project components at a single site may require the developers to incur substantial avoidable costs and may significantly increase the amount of federal subsidy for any given amount of electricity produced from Biogas generated by the project.

The purpose of this letter is to seek administrative clarification that the term "qualified facility," as used in section 48 and ARRA section 1603, is properly interpreted in a manner that permits Biogas projects to qualify for the ITC and the 1603 Grant without unnecessary restrictions on the siting and ownership of project components.

<u>Background Regarding Interpretive Issues</u>

I understand that the Treasury Department is grappling with interpretive issues that arise under section 48(a)(5) and ARRA section 1603(d)(1) by reason of several passages in section 48 and ARRA section 1603 that incorporate the term "qualified facility," giving that term the

[1] Except where otherwise indicated, all "section" references in this letter are to sections of the Internal Revenue Code of 1986, as amended, and all "ARRA section" references are to sections of the American Recovery and Reinvestment Act of 2009, P.L. 111-5.

meaning it has when used in section 45. The cross references give rise to interpretive issues because section 45, on the one hand, and section 48 and ARRA section 1603, on the other hand, use the term "qualified facility" for entirely different purposes, which may be summarized as follows:

- Section 45 provides a production tax credit ("PTC") based on the production of electricity from a qualifying energy resource, and section 45 uses the term "qualified facility" solely for purposes of determining whether particular equipment that produces electricity from an eligible energy resource satisfies the placed-in-service requirements applicable to that resource.

- Section 48 and ARRA section 1603 provide an investment tax credit (the "ITC") and grant (the "1603 Grant"), respectively, based on the cost of property placed in service within specified time periods that in all cases are more restrictive than the placed-in-service requirements under section 45. The term "qualified facility" is used in section 48 and ARRA section 1603 solely for the purpose of extending the ITC and the 1603 Grant to property used in connection with the production of electricity from one of several energy resources specified in section 45.

The Treasury Department has already recognized that the scope of a "qualified facility" for purposes of ARRA section 1603 is not the same as the scope of a "qualified facility" for purposes of section 45. The guidance issued by the Treasury Department under ARRA section 1603 in July 2009 and revised in March 2010 (the "ARRA Guidance") states, at p. 11:

> In the case of an open-loop biomass, closed-loop biomass, or municipal solid waste facility, an integral part of the qualified facility includes property used at the plant site for unloading, transfer, storage, reclaiming from storage, or preparation (shredding, chopping, pulverizing, or screening) of the material to be processed at the plant.

This treatment of storage and preparation equipment as part of a "qualified facility" is markedly different from the guidance under section 45 provided by section 3.01(1) of Notice 2008-60, which states:

> Thus, a qualified open-loop biomass facility includes all burners and boilers (whether or not burning open-loop biomass), any handling and delivery equipment that supplies fuel directly to and is integrated with such burners and boilers, steam headers, turbines, generators, and all other depreciable

> property necessary to the production of electricity. The facility does not include (i) property used for the collection, processing, or storage of open-loop biomass before its use in the production of electricity * * *." (Emphasis added.)

The difference between the guidance in Notice 2008-60 and the quoted language in the ARRA Guidance is sensible, reflecting the disparate functions of the term "qualified facility" in section 45 and ARRA section 1603. Additional guidance should be issued under both section 48 and ARRA section 1603 providing a clearer specification of what constitutes a "qualified facility" for purposes of those provisions.[2]

Proposed Guidance

The specific items of guidance listed below should be issued as soon as possible to facilitate the development of alternative energy resources by Biogas project developers that, for reasons of economic efficiency, do not produce electricity at the same site as the property that derives gas from waste and/or do not own all of the components of the waste-to-electricity process.

Item 1: For purposes of section 48(d)(5)(C) and ARRA section 1603(d)(1), all of the property owned by a person that –

(1) constitutes, or is used in connection with, equipment that produces electricity using one of the energy resources described in paragraph (1), (2), (3), (4), (6), (7), (9), or (11) of section 45(d),

(2) is used as an integral part of a process of producing electricity from that energy resource, and

(3) is placed in service at a time specified in the paragraph of section 45(d) applicable to that energy resource,

constitutes a "qualified facility," regardless of whether all of the property used as integral parts of the process is owned by the same person or is located at the same site.

Item 2: Neither the section 48 credit nor the ARRA section 1603 grant is allowed with respect to the basis of a qualified facility if that facility constitutes, or is used in

[2] It is particularly urgent that such guidance be issued under ARRA section 1603, because the processing of grant applications by the Treasury Department is the only administrative process for determining the eligibility of property for a grant.

connection with, equipment producing electricity for which a credit under section 45 is claimed by the producer of the electricity.

Discussion

A. Policy Considerations

The proposed items of guidance are intended to achieve the following objective:

- Enable project developers and other property owners to qualify for the ITC or 1603 Grant with respect to property that is part of a combination of equipment that produces electricity from wind, closed-loop biomass, open-loop biomass, geothermal energy, landfill gas, trash, qualified hydroelectric power, or marine and hydrokinetic renewable energy and is an integral part of the process of producing electricity from the energy resource in question.

The examples set forth below illustrate the manner in which the proposed guidance achieves the foregoing objective, focusing on property used in the production of electricity from Biogas.

In each of the examples, Company A constructs, owns, and operates at Site X Biogas production property consisting of the following components: (1) a receiving area containing equipment for removing and sorting waste material from trucks, (2) a pretreatment area in which contaminants are removed and the remaining waste material is ground up and otherwise treated in preparation for digesting, (3) anaerobic digestion tanks and conditioning equipment in which the pretreated waste is broken down to produce Biogas containing approximately methane and carbon dioxide, with hydrogen sulfide and excess moisture removed ("Conditioned Biogas") and residual organic matter with a high water content ("Digestate"). Company A must incur costs either to dispose of the Digestate or to process the Digestate into saleable products. All of the property in each example is placed in service in 2011.

> **Example (1):** Company A also constructs generating equipment at Site X. Company A's Conditioned Biogas is used as a fuel in Company A's generating equipment to produce electricity.
>
> **Example (1)(a):** The facts are the same as in Example (1), except that the generating equipment at Site X is owned by Company B, a person unrelated to Company A, and Company A sells the Conditioned Biogas to Company B for use in generating electricity at Site X.
>
> **Example (1)(b):** The facts are the same as in Example (1)(a), except that, instead of selling the Conditioned Biogas to Company B, Company A leases

the generating equipment from Company B and uses the leased equipment to produce electricity at Site X.

Example (2): Company A constructs and installs additional Biogas production equipment at Site Y. Company A constructs and installs generating equipment at Site Y but not at Site X. Company A constructs a dedicated gas pipeline to transport Conditioned Biogas from Site X to Site Y for use in the production of electricity at Site Y.

Example (2)(a): The facts are the same as in Example (2), except that, instead of constructing its own pipeline between Site X and Site Y, Company A utilizes the pipeline of an existing gas utility. In order to meet the requirements of the pipeline, Company A constructs additional equipment on Site X to upgrade the Conditioned Gas ("Upgrading Equipment"), principally by removing carbon dioxide.

Example (2)(b): The facts are the same as in Example (2)(a), except that, instead of using the upgraded Biogas in Company A's generating equipment at Site Y, Company A sells the upgraded Biogas to Company C, a public utility, for use in producing electricity at Site Z.

Analysis of Example (1). In Example (1), Company A is entitled to the section 45 production credit with respect to the electricity produced by the equipment at Site Y, and it is difficult to imagine any basis for concluding that any of the property at Site X is not "part of a qualified facility" within the meaning of ARRA section 1603(d)(1) or "part of a qualified investment credit facility" within the meaning of section 48(a)(5)(A). The ARRA Guidance states that qualified property includes "tangible property that is both used as an integral part of the activity performed by qualified facility and located at the site of the qualified facility" (p. 11) and that "[a] landfill gas facility is a facility producing electricity from gas derived from the biodegradation of municipal solid waste" (p. 13).[3] All of Company A's property at Site X is used as an integral part of the activity performed by Company A's qualified facility. The guidance proposed in this letter would produce the same result.

Analysis of Example (1)(a). Neither the applicable statutory provisions nor the ARRA Guidance provide clear guidance regarding the treatment of Company A's property in Example (1)(a). Company A does not own property that produces electricity, and Company

[3] It is possible that the Treasury Department would consider Company A's property to constitute a "trash facility," which is "a facility, other than a landfill gas facility, that uses municipal solid waste to produce electricity," rather than a landfill gas facility. *See* ARRA Guidance, at p. 13. In the balance of this letter it will be assumed that "landfill gas facility" is the property classification.

A could not qualify for the production tax credit under section 45, but there is no requirement in section 48 or ARRA section 1603 that the owner of a qualified facility be a producer of electricity. Indeed, the requirement in section 45 that the taxpayer sell electricity to unrelated persons[4] is omitted from section 48 and ARRA section 1603. The only requirement in the latter provisions regarding the production of electricity is that Company A's property be "part of" a facility that produces electricity. In Example (1)(a), Company B could qualify for the section 45 credit, and, as long as Company B does not claim that credit, there is no sound reason that Company A should not be allowed to claim an ITC or grant to the same extent as in Example (1). Under the guidance proposed in this letter, Company A would be entitled to the ITC or the 1603 Grant with respect to its Biogas production property at Site X.

Analysis of Example (1)(b). In Example (1)(b), it is possible that neither Company A nor Company B can qualify for the credit under section 45, as the credit is allowed only with respect to electricity "produced by the taxpayer . . . at a qualified facility,"[5] and, in the case of a landfill gas facility, the term "qualified facility" refers only to a facility "owned by the taxpayer."[6] Company B, or course, does not produce electricity, and Company A does not own property that produces electricity.[7] Nonetheless, in the absence of compelling language in the applicable statutes,[8] there is no good reason to penalize Companies A and B for dividing capital investment risks through a leasing arrangement by denying or reducing the ITC or 1603 Grant – the project is exactly the kind of project that Congress sought to subsidize by making these cost-based incentives available. Under the guidance proposed in this letter, Company A and Company B would each be eligible for the ITC or 1603 Grant based on the cost of its own property used in the waste-to-electricity process.

Analysis of Example (2). Example (2) presents the question of whether Company A should be penalized for constructing a single large set of generating equipment at Site Y and transporting Conditioned Gas from Site X to Site Y, rather than (1) constructing a smaller set of generating equipment at each site or (2) transporting all of Company's untreated waste to Site Y and increasing the capacity of all of the equipment constructed at Site Y. In the

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4 *See* section 45(a)(2)(B).

5 Section 45(a)(2)(A).

6 Section 45(d)(6).

7 *See* Notice 2008-60, sec. 3.01(1), which states that, for purposes of section 45 production tax credit, an open-loop biomass facility does not include "property used for the collection, processing, or storage of open-loop biomass before its use in the production of electricity." It is possible that the IRS would take the position that, in Example (1)(b), Company A's property is not part of a landfill gas facility for purposes of section 45.

8 The flexibility permitted by the pertinent provisions in the statutes is discussed in section B. of this letter.

absence of compelling language in the applicable statutes, there is no reason for penalizing Company A for making this decision. Under the guidance proposed in this letter, Company A would be eligible for the ITC or 1603 Grant based on the cost of all of its equipment at both sites. Company A also should be eligible for the ITC or 1603 Grant with respect to the cost of the pipeline, as the pipeline is an integral part of the process of producing electricity from Company A's Biogas.

Analysis of Example (2)(a). Example (2)(a) presents the question of whether Company A should be penalized for investing in equipment that upgrades its Conditioned Biogas rather than investing in a dedicated pipeline. There are two subsidiary questions. The first is whether the transportation of Company A's Biogas through a common pipeline with gas from other sources should prevent Company A's property at Site X and/or Site Y from being treated as part of a "facility producing electricity from gas derived from the biodegradation of municipal solid waste." The second question is whether the Upgrading Equipment should be viewed as an integral part of the process of producing electricity from Biogas. There do not appear to be any policies that would support a requirement that the owner of equipment build its own dedicated pipeline connecting components of its waste-to-electricity process. Under the guidance proposed in this letter, Company A would be eligible for the ITC or 1603 Grant based on the cost of all of its equipment at both sites. Company A also should be eligible for the ITC or 1603 Grant with respect to the cost of the upgrade equipment at Site X, as that equipment is an integral part of the process of producing electricity at Site Y from the Biogas Company A produces at Site X.

Analysis of Example (2)(b). Example (2)(b) presents the question of whether property that is constructed to produce Biogas for the purpose of producing electricity should be ineligible for the ITC or 1603 Grant if the electricity is produced by an unrelated person. Example (2)(b) is very similar to Example (1)(a), except that, in Example (2)(b), it is possible that Company C's generating equipment was placed in service before October 23, 2004, and therefore cannot be considered part of a "qualified facility" under section 45(d)(6).[9] There does not, however, appear to be any sound policy disfavoring the allowance of the ITC or 1603 Grant for newly constructed property that harnesses an energy resource listed in section 48 or ARRA section 1603 for use in producing electricity merely because the electricity is produced by existing generating equipment.

In fact, if Company A's property is eligible for the ITC or 1603 Grant under the facts of Example (2)(b), the amount of federal subsidy for any given amount of electricity produced

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[9] Under section 45(d)(6), in the case of a landfill gas facility, the term "qualified facility" refers only to facilities placed in service after the date of enactment of section 45(d)(6). Section 45(d)(6) was enacted by section 710(b)(1) of P.L. 108-357, the American Jobs Creation Act of 2004, which was enacted on October 22, 2004.

from the Biogas produced by Company A at Site X will be significantly lower than the amount of federal subsidy that Company A would receive if Company A produced its own electricity, as under the facts of Example (1). There are two reasons for this.

First, under the facts of Example (1), Company A is entitled to the ITC or 1603 Grant with respect to the cost basis of the generating equipment as well as the cost basis of the equipment used to produce Conditioned Biogas. The cost of the Upgrading Equipment constructed by Company A in Example (2)(b) is likely to be significantly less than the cost of constructing generating equipment in Example (1).

Second, electric utilities generally use combined cycle turbines that convert gas to electricity at efficiency rates that historically have been higher than the efficiency rates of generator sets that are used to produce electricity onsite where Biogas is produced.

For the foregoing reasons, it is an appropriate policy choice to allow the ITC and 1603 Grant with respect to Biogas production equipment at one site when the output of that equipment is sold to a third party for production of electricity at another site.

In reaching the foregoing conclusion, we are mindful that the IRS appears to have taken a different position in connection with the eligibility of electricity for the PTC under section 45. That is, in Notice 2008-60, the IRS identifies the components of an open-loop biomass facility in a manner that denies the 10-year PTC period to electricity produced by generating equipment placed in service before October 22, 2004, even if the generating equipment produces electricity using open-loop biomass produced by equipment constructed after that date.[10]

Positions taken by the IRS in connection with the implementation of the PTC, however, should not dictate the positions taken by the IRS and the Treasury Department in implementing the ITC and the 1603 Grant, because the policy considerations that arise in connection with the ITC and the 1603 Grant are different from the policy considerations that arise in connection with the PTC. In the case of the PTC for electricity produced from open-loop biomass, the credit period is based on when the "facility" producing the electricity was placed in service, and it would be administratively difficult if the credit period for electricity produced by a single generator could depend on the placed-in-service date of property other than the generator. The ITC and the 1603 Grant, however, are based entirely on the cost of equipment placed within the applicable placed-in-service window, and no administrative problem arises when individual components of a waste-to-electricity process are viewed as independent "qualified facilities."

[10] *See* Notice 2008-60, sec. 3.01.

As noted in the discussion beginning on page 2 above, the Treasury Department has already recognized that the scope of a "qualified facility" for purposes of ARRA section 1603 is not the same as the scope of a "qualified facility" as determined by Notice 2008-60 for purposes of section 45. The Treasury Department and the IRS should readily agree that the policies behind Notice 2008-60 should not dictate the application of section 48 and ARRA section 1603 in situations like Example (2)(b).

* * *

The foregoing examples demonstrate that the proposed guidance achieves appropriate policy objectives.

B. <u>Technical Considerations</u>

It is appropriate to consider whether the items of guidance proposed in this letter are supported, or at least permitted, by the applicable statutory provisions.

The definition of "qualified facility," as that term is applicable to landfill gas facilities, is set forth in section 45(d)(6), which states:

> In the case of a facility producing electricity from gas derived from the biodegradation of municipal solid waste, the term "qualified facility" means any facility owned by the taxpayer which is originally placed in service after the date of the enactment of this paragraph and before January 1, 2014.

Notably, this provision does not state that the term "qualified facility" means "a facility that (1) produces electricity from gas derived from the biodegradation of municipal solid waste, (2) is owned by the taxpayer, and (3) is originally placed in service after the date of the enactment of this paragraph and before January 1, 2014." That is, the literal language of section 45(d)(6) does not impose a requirement that, in order for a "facility" relating to Biogas to be a "qualified facility," the facility itself must produce electricity. Rather, the statute provides that "in the case of a facility" producing electricity from Biogas, "any facility" that is owned by the taxpayer and is placed in service within the prescribed period is a "qualified facility." This language can be read to have the following meaning: "When considering a combination of items of property that, taken together (and regardless of where they are located and by whom they are owned), produce electricity from Biogas,[11] the term

[11] This is consistent with the dictionary definition of "facility." For example, in the *American Heritage Dictionary*, Second College Edition, the relevant definition of "facility" is "5. Something created to serve a particular function."

'qualified facility' means any of such items of property that are owned by the taxpayer and are placed in service within the prescribed period."

The possibility that the literal language of section 45(d)(6) makes it possible to identify a group of assets that do not themselves generate electricity as a "qualified facility" cannot have any meaningful consequences for purposes of the PTC, because the PTC is allowable only with respect to electricity production.[12] However, this plausible literal interpretation of section 45(d)(6) enables the IRS and the Treasury Department to treat the property owned by a taxpayer (or 1603 Grant applicant) as a "qualified facility" for purposes of section 48(a)(5) and ARRA section 1603(d)(1) even if the taxpayer (or Grant applicant) does not itself produce electricity.

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I would be happy to discuss this further at your convenience.

Sincerely,

LANE POWELL PC

Neil D. Kimmelfield

NDK:jat

cc: Mr. Jeffrey Van Hove, Acting Tax Legislative Counsel
Mr. John Parcell, Deputy Tax Legislative Counsel
Mr. Charles Ramsey, Branch Chief, Pass-Throughs & Special Industries, Br. 6

[12] Section 45(a) will not allow a PTC merely because the assets constitute a "qualified facility," as no electricity is produced "at" that facility. Assuming those assets are an integral part of a waste-to-electricity process, the PTC will be allowed with respect to the electricity produced by the process only if the generating equipment that is part of the process constitutes a "qualified facility."