McDermott
Will & Emery

Key Energy-Related Tax Provisions in the 2013 Budget Proposal

February 17, 2012

President Obama's recently released budget proposal for the 2013 fiscal year contains energy-related tax provisions, including an extension of the Section 1603 grant in lieu of investment credits through 2012.

The Obama administration released its revenue proposal (Proposal) for the fiscal year 2013 on February 13, 2012. The Proposal would expand several energy-related tax provisions, some of which were also proposed in the 2012 revenue proposal, and would repeal others. (See Energy Related Tax Provisions in the President's 2012 Budget [LINK TO: http://mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/2b7c9a14-d1de-48d1-ada1-d13fef185fad.cfm] for more information on the energy tax provisions in the 2012 proposal.)

Following is a summary of some of the energy-related tax provisions contained in the Proposal and explained further in the U.S. Department of Treasury's general explanation of the Proposal (Green Book).

Extension of the Production Tax Credit and Investment Tax Credit for Wind Facilities Ut ex el

The production tax credit (PTC) for wind facilities provided pursuant to Section 45 of the Internal Revenue Code of 1986, as amended (Code), is set to expire on December 31, 2012. The PTC is a credit currently equal to 2.2 cents per kilowatt hour that is taken over a 10-year period beginning on the date a wind facility is placed in service. Under current law, taxpayers with wind facilities that are eligible for the PTC can elect to instead take the investment tax credit (ITC) pursuant to Section 48 of the Code. The ITC is a one-time credit taken in the year a wind facility is placed in service equal to 30 percent of the qualifying costs of such wind facility. Wind facilities placed in service after December 31, 2012, would no longer be eligible for either the PTC or ITC.

As explained in the Green Book, the Proposal would extend the PTC and ITC for wind facilities to wind facilities and property placed in service in 2013, thus extending PTC and ITC benefits for wind facilities for one additional year.

Extension of the Grant in Lieu of Investment Tax Credits Pursuant to Section 1603 of the Recovery Act Through 2012, and Creation of a Refundable ITC

Section 1603 of the American Recovery and Reinvestment Act of 2009 (Recovery Act) provides for a cash grant in lieu of the ITC equal to 30 percent of eligible renewable energy project costs. The grant is currently available to renewable energy projects that were placed in service in 2009, 2010 or 2011, or to renewable energy projects that meet the requirements for "beginning construction" in those years and are placed in service prior to the expiration date of the ITC for the applicable renewable energy technology. For additional details and explanations with respect to the grant, see Treasury Updates Section 1603 Cash Grant Guidance and Frequently Asked Questions. [LINK TO: http://mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/8b149ec7-6c36-461f-bdae-c8050d671513.cfm]

According to the Green Book, the Proposal would extend the cash grant program to all ITC eligible property placed in service in 2012 (including property on which construction begins in 2012). For property that does not meet the grant placed in service or beginning of construction requirements in 2012, the Proposal would replace the grant with a refundable tax credit administered by the Internal Revenue Service. The refundable tax credit would be available for property on which construction begins in 2009, 2010, 2011, 2012 or 2013. The credit would be allowed with respect to property placed in service in 2013 (in the case of property—including wind facility property—that is part of a facility eligible for the PTC) and for property placed in service in 2013, 2014, 2015 or 2016 (in the case of any other energy property). Qualification requirements for the refundable credit would be the same (except for the effective date provisions) as the qualification requirements currently applicable under the grant program.

Expansion of Tax Credits for Investment in Eligible Property Used in a Qualified Advanced Energy Manufacturing Project

The Recovery Act provided a tax credit equal to 30 percent of a taxpayer's qualified investment in eligible property used in a "qualifying advanced energy project" pursuant to Section 48C of the Code. A "qualifying advanced energy project" is a project that re-equips, expands or establishes a manufacturing facility for the production of: 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; and other advanced energy property designed to reduce greenhouse gas emissions.

This credit was previously capped at $2.3 billion, which, according to the Green Book, resulted in the funding of less than one-third of the technically acceptable applications for such credit that were received, because there were not enough credits to allocate to all the technically acceptable applications. The Proposal would authorize an additional $5 billion credits for advanced energy manufacturing projects. In addition, it would permit taxpayers to apply for the credit with respect to only part of their qualified investment in a project on the basis that the claiming of this credit for only part of a qualified investment reduces the burden on the government for the project costs. The Green Book explains that one of the factors to be considered in determining whether to allocate credits to a project would be whether a taxpayer has applied for a partial credit as opposed to a credit for the entire project. Applications for the credit should be made during the two-year period beginning on the date on which the additional credit authorization is enacted.

To read more on the application process and criteria for this credit under the previously authorized $2.3 billion cap, see Applications Now Accepted for Advanced Energy Project Tax Credits. [LINK TO: http://mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/3d09ec53-4fac-4948-9357-76170277c4af.cfm]

Extension and Expansion of the New Markets Tax Credit

Congress previously allocated $3.5 billion for qualified investments in low-income communities made in each of the 2010 and 2011 years under the new markets tax credit (NMTC) program pursuant to Section 45D of the Code. The NMTC is a credit taken over seven years and is generally equal to 5 percent of the amount of the taxpayer's qualified investment for the first three years, and 6 percent of such investment for the last four years. Currently, the NMTC can be used to offset regular federal income tax liability, but cannot be used to offset alternative minimum tax (AMT) liability.

The Green Book indicates the Proposal would authorize two more rounds of NMTC allocations (for 2012 and 2013), with an allocation amount of $5 billion for each round. The Proposal would also permit NMTC amounts resulting from qualified investments made after December 31, 2011, to offset a taxpayer's AMT liability.

In addition, the Green Book indicates a credit potentially structured in a similar way to the NMTC will be established to provide tax credits for investments in communities that have suffered a major job loss event. The Green Book explains this credit would provide incentives to such communities that might not necessarily qualify as low-income communities eligible for the NMTC.

Extend 100-Percent Bonus Depreciation for Certain Property

Currently, an additional first-year depreciation deduction equal to 50-percent of the cost of qualified property is allowed for qualified property placed in service before January 1, 2013. Under legislation passed in 2010, this additional first-year depreciation deduction was equal to 100 percent of the cost of qualified property that was acquired and placed into service by the taxpayer between September 8, 2010, and January 1, 2012. For more information on the additional first-year depreciation deduction, see IRS Clarifies When 100 Percent Bonus Depreciation Applies. [LINK TO: http://mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/769ed856-98dc-4967-b388-1fb50e9b80e4.cfm]

The Proposal would extend the 100-percent additional first-year depreciation deduction for one additional year. Thus, qualified property acquired and placed in service through 2012 (2013 for certain property with a longer production period) is eligible for the 100-percent first-year depreciation deduction. The extension would be effective for qualified property placed in service after December 31, 2012. As with prior additional first-year depreciation deductions, taxpayers would be permitted to elect out of such deduction and depreciate under the ordinary depreciation rules.

Extension of the Section 45M Credit for Energy-Efficient Appliances

The Tax Relief and Job Creation Act of 2010 expanded the manufacturers' energy efficient appliance credit (MEEAC) for certain types of qualified energy efficient appliances produced by a taxpayer during the 2011 calendar year. The Green Book added the MEEAC to its list of expiring provisions the Proposal would extend through December 31, 2013.

Replacement of Deduction for Energy-Efficient Commercial Buildings with Tax Credit

The Proposal would provide for a tax credit to replace the existing deduction for energy-efficient commercial buildings. The tax credit would apply to qualified property that is designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation and hot water systems of a building by 20 percent or more in comparison to certain reference buildings. In contrast, the deduction generally applies to similar property designed to reduce the same costs by 50 percent.

This tax credit would be limited to $0.60 per square foot in the case of energy-efficient commercial building property designed to reduce the total annual energy and power costs by at least 20 percent but less than 30 percent, to $0.90 per square foot for qualifying property designed to reduce the total annual energy and power costs by at least 30 percent but less than 50 percent, and to $1.80 per square foot for qualifying property designed to reduce the total annual energy and power costs by 50 percent or more. Special rules would apply to allow the credit to benefit a real estate investment trust or its shareholders. This tax credit would be available for property placed in service during the 2013 calendar year.

Taxation of Carried Interests

The Proposal includes as a revenue-raising provision the taxation of carried interests, a legislative change that has been proposed several times over the past few years. This proposed legislation generally targets profits interests in partnerships issued in exchange for services provided by the recipient partner. The Green Book provides that the Proposal would tax a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, as ordinary income. In addition, the Proposal would require the recipient partner to pay self-employment taxes on such income, and gain recognized on the sale of an ISPI would generally be taxed as ordinary income, rather than capital gain. The Green Book defines an ISPI as a carried interest in an "investment partnership" that is held by a person who provides services to the partnership. A partnership is an "investment partnership" if the majority of its assets are investment-type assets, which the U.S. Department of Treasury describes as certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets, but only if more than half of the partnership's contributed capital is from partners in whose hands the interests constitute property held for the production of income.

Additional nuances to the taxation of carried interests provision exist in the Proposal, including an anti-abuse rule targeting convertible or contingent debt, options or other derivative instruments with respect to investment partnerships. The provision would be effective for taxable years ending after December 31, 2012.

Expansion of the Research and Experimentation Credit

The Proposal would expand and make permanent the credit for research and experimentation, which expired at the end of 2011. The research and experimentation credit equals 20 percent of eligible costs 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. The Proposal would also enhance the elective simplified research credit under this provision from a 14 percent credit to a 17 percent credit. These changes would be effective after December 31, 2011.

Ordinary Gain or Loss Treatment for Section 1256 Contracts Entered into by Commodities "Dealers"

The Proposal has recycled an item that was included in the last two budget proposals, which, if adopted, would require "dealers" in commodities and commodities derivatives to treat the income from their dealer transactions in Code Section 1256 contracts as resulting in ordinary gain or loss, rather than capital.

As a general matter, Code Section 1256 contract gains or losses are capital unless altered by another rule. Other rules that currently convert Code Section 1256 contract gains and losses to ordinary are the hedging rules of Code Section 1221 and the dealer and trader mark to market elections under Code Section 475.

This proposal would essentially override the general starting point of capital gain or loss from Code Section 1256 contracts for eligible dealers, without having to rely on the hedging rules or Code Section 475 mark to market elections. If adopted, the proposal would be effective for taxable years beginning after the date of enactment. The Proposal does not, however, provide any guidance on whether or when exchange-traded positions are considered entered into in a dealer capacity.

Extension of Certain Other Expiring Energy-Related Provisions

The Proposal would also extend the following through December 31, 2013, as listed in the Green Book:

- Incentives for biodiesel and renewable diesel
- Credit for construction of energy-efficient new homes
- Incentives for alternative fuel and alternative fuel mixtures
- Special rule to implement electric transmission restructuring
- Cellulosic biofuel producer credit
- Special depreciation allowance for cellulosic biofuel plant property
- Alternative fuel vehicle refueling property (non-hydrogen refueling property) credit
- Section 25C credit for nonbusiness energy property
- Plug-in hybrid conversion credit
- Green bonds

Elimination of Fossil Fuel Preferences

The Proposal's expenditures are to be funded in part by the elimination of fossil fuel preferences. The Proposal would eliminate most fossil fuel tax preferences, including:

- Repealing the enhanced oil recovery credit for taxable years beginning after December 31, 2012
- Repealing the credit for oil and gas produced from marginal wells for production in taxable years beginning after December 31, 2012
- Repealing expensing for intangible drilling costs and 60-month amortization of capitalized intangible drilling costs for costs paid or incurred after December 31, 2012
- Repealing the deduction for qualified tertiary injectant expenses for amounts paid or incurred after December 31, 2012
- Repealing the exception to the passive loss limitation for working interests in oil and natural gas properties for taxable years beginning after December 31, 2012
- Repealing percentage depletion for oil and natural gas wells, as well as for coal and other hard mineral fossil fuels, for taxable years beginning after December 31, 2012; taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in such properties
- Increasing the geological and geophysical amortization period from two years to seven years for independent oil and gas producers for amounts paid or incurred after December 31, 2012
- Repealing expensing, 60-month and 10-year amortization for exploration and development costs relating to coal and other hard-mineral fossil fuels for costs paid or incurred after December 31, 2012
- Repealing capital gains treatment of coal and lignite royalties in favor of taxing those royalties as ordinary income, effective for amounts realized in taxable years beginning after December 31, 2012
- Repealing the domestic manufacturing deduction for oil and natural gas companies for taxable years beginning after December 31, 2012; a similar proposal would apply to coal and hard mineral fossil fuel production

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

Madeline Chiampou: +212 547 5643 mchiampou@mwe.com

Bill Pomierski: +1 312 984 7531 wpomierski@mwe.com

Martha Groves Pugh: + 1 202 756 8368 mpugh@mwe.com

Phil Tingle: +1 305 347 6536 ptingle@mwe.com

Brian Levy: + 1 305 329 4419 blevy@mwe.com

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

The material in this publication may not be reproduced, in whole or part without acknowledgement of its source and copyright. Key Energy-Related Tax Provisions in the 2013 Budget Proposal is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their McDermott Will & Emery lawyer or other professional counsel before acting on the information contained in this publication.

© 2012 McDermott Will & Emery. The following legal entities are collectively referred to as "McDermott Will & Emery," "McDermott" or "the Firm": McDermott Will & Emery LLP, McDermott Will & Emery AARPI, McDermott Will & Emery Belgium LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, MWE Steuerberatungsgesellschaft mbH, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. These entities coordinate their activities through service agreements. McDermott has a strategic alliance with MWE China Law Offices, a separate law firm. This communication may be considered attorney advertising. Prior results do not guarantee a similar outcome.