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State Tax Credits & Clean Energy Opportunities

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State Tax Credits: Policy Considerations

- State tax credits are typically used to further a social policy, such as clean energy, rehabilitation of historic buildings, or job creation in challenged areas.
- Legislators often select tax credits to implement policy goals because the tax law and state tax authority provide the infrastructure to distribute the incentive and audit compliance with the requirements of the incentive.

State Tax Credits: Policy Considerations (cont.)

- If tax credits were not used, the legislature would have to crate a new governmental body to administer the incentive program which could be a costly and slow process.

State Tax Credits: The Policy Challenge of Tax Appetite

- Often the entities that actually engage in the activity that qualifies for the credit do not have sufficient state tax liability to garner a current economic benefit from the credit.

State Tax Credits: Tax Appetite (cont.)

- Legislators are left with 3 choices to address the problem of limited tax appetite

  1. Accept the state tax credit will not provide as much incentive/ motivation to undertake the targeted activity.

     a. Structures to monetize tax credits are discussed below but entail financing and transaction costs reducing the net benefit and are not economic for small projects

  2. Make the state tax credit transferable – but then the transferee's payment in consideration for the tax credit would typically be at a discount to the face value of the tax credit.

     a. Results in windfall for the wealthy purchasers of the credits, and they did not undertake the targeted activity.

     b. The discounted portion of the payment does not further the policy goal. E.g., clean energy developer has no state tax appetite but is entitled to a $100 state tax credit. It sells the credit for $75 to wealthy taxpayer. So it cost the state $100 in foregone revenue to provide a $75 incentive.

State Tax Credits: Tax Appetite (cont.)

3. Make the credits refundable. So there is no discount to the credit.
   a. Only practical drawback is the complexity of refundability.
   b. A political drawback is some legislators oppose refundable tax credits, on philosophical grounds, so refundability may make it difficult to obtain support from certain legislators.

State Tax Credits: Federal Tax Consequences

- Transferable state tax credits – consideration received for the transfer is taxable income for federal (and likely state) purposes to the taxpayer that earned the credit , i.e., the seller of the credit.
- The transferee realizes federal taxable income equal to the difference between the price it paid for the credit and the reduction in its state tax liability from the credit.
- Refundable state tax credit – Cash from refund is federal taxable income to the recipient. In some states, the refund is also taxable income for state purposes (e.g., Hawaii).
- As an economic matter (not a tax law matter), even "regular" state tax credits are effectively reduced in value by the foregone federal deduction for state taxes. E.g., a $100 South Carolina tax credit is only a $65 tax benefit to a corporation subject to a 35% federal tax that could have used the deduction for South Carolina taxes to reduce its federal tax liability.

State Tax Credits: Depreciable Tax Basis

- Generally, state tax credits do not reduce federal tax basis, and federal tax credits do not reduce state tax basis. E.g., a North Carolina 35% solar tax credit (now expired); a 30% federal investment tax credit; and the eligible basis of the project is $100.

  Federal: $30 investment tax credit per I.R.C. § 48
  50% basis adjustment per I.R.C. § 50 (unrelated to the state tax credit), so depreciate $85

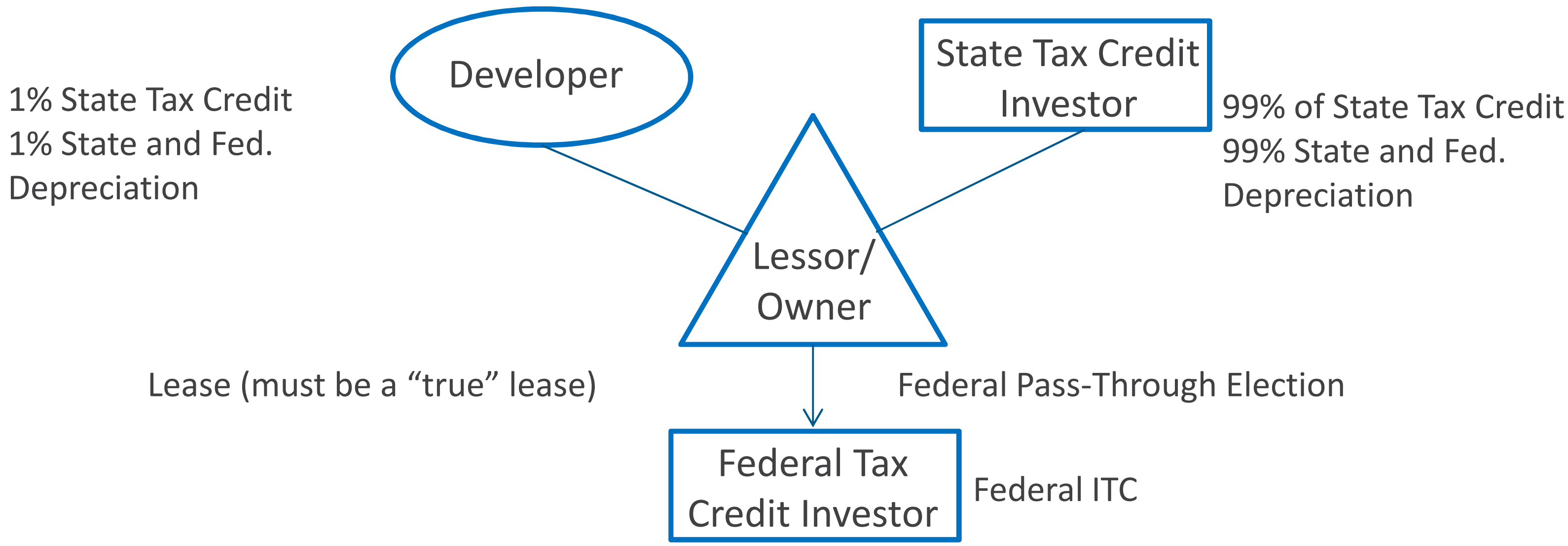
  North Carolina: $35 NC tax credit
  Depreciate $100

Transactions for Activities that Qualify for State and Federal Tax Credits

- Rarely does the party undertaking the activity that qualifies for tax credits have the tax appetite to use them efficiently.
- Rarely does the investor who will have appetite for <u>federal</u> tax credits have appetite for the particular state tax credits too.
  - Not many large federal corporate taxpayers have significant tax liabilities in states like South Carolina that provide energy state tax credits.
- So unless the state tax credits are transferable or refundable, two "tax equity" investors are needed.

Bifurcation of Federal & State Tax Credits – Leases

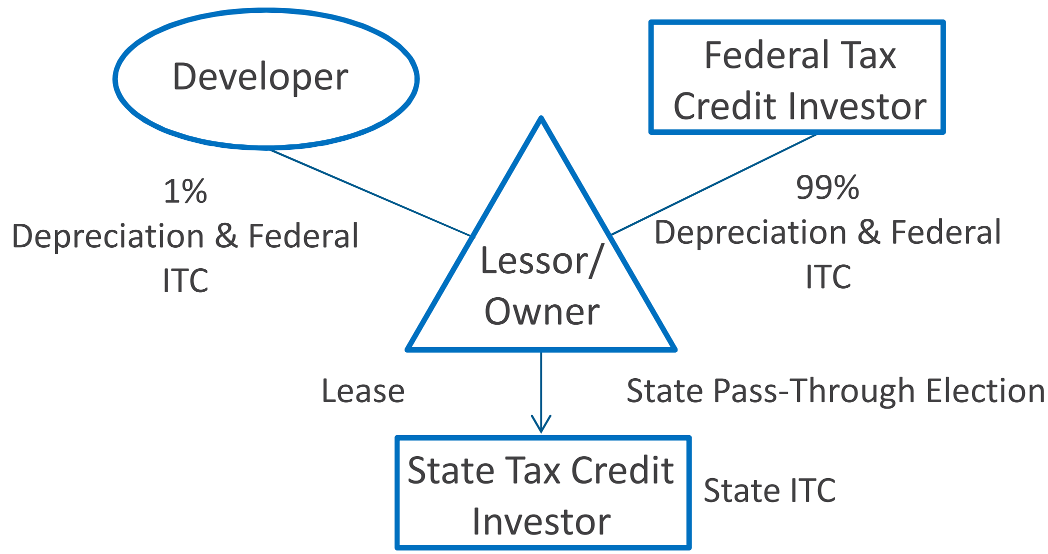
- A lessor of property eligible for federal energy investment tax credits or historic tax credits can make an election to pass the federal credit through to the lessee. See I.R.C. § 50(d)(5) (referencing old I.R.C. § 48(d)).



- Challenges: Will the *state* tax credit investor increase its capital contribution to reflect the benefit of *federal* depreciation or is the federal depreciation “wasted”?

Bifurcation of Federal & State Tax Credits – Leases

- If the state permits a lease *pass-through election* as was possible when NC provided a solar tax credit, then make the state tax credit investor the lessee:



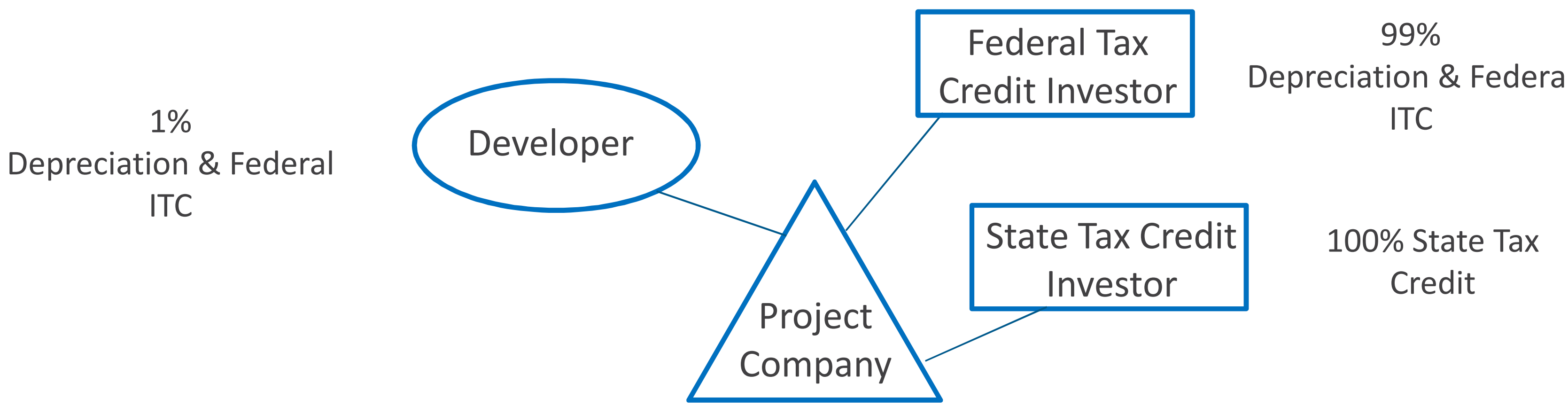
Ensures the federal depreciation benefit is available to the investor with federal tax appetite.

Bifurcation of Federal & State Tax Credits – Partnerships

- Does the state's tax law require that the state tax credits be allocated in accordance with I.R.C. § 704(b) principles? Utah is an example of this. See Utah Tax Code, § 59-10-1402 ("taxpayer's distributive share of income, gain, loss, deduction or credit – as determined under § 704 et seq. of the I.R.C.")
  - If so, then in a partnership it is not possible to allocate 99% of the federal tax credits to the federal investor and 99% to the state investor because both allocations cannot satisfy I.R.C. § 704(b) principle.
- If the state credit is refundable and the state follows I.R.C. § 704(b) principles, must the refund be paid to the partners in accordance with their I.R.C. § 704(b) percentage allocations? Or for instance can the refund be 100% (or 99%) paid to the Developer who has only a 1% I.R.C. § 704(b) allocation?

Bifurcation of Federal & State Tax Credits – Partnerships

- Does the state allow a special allocation of the tax credit to any member without regard to I.R.C. § 704(b)? If so the partnership can be structured as follows –



Care must be used to ensure that for federal purposes the special allocation to the State Tax Credit Investor is not a deemed sale of the state tax credit

Bifurcation of Federal & State Tax Credits – Partnerships (cont.)

- Even if the state tax credit is not “transferable” under state law, the IRS can assert a partnership transaction is for federal purposes a sale of the state tax credit. *See Virginia Historic Tax Credit Fund 2001 LP v Comm’r*, 639 F.3d 129 (4^{th} Cir. 2011) (“there was no true entrepreneurial risk faced by” certain purported partners). Facts of the transaction were on the aggressive side.
- Factors 4^{th} Cir found indicated lack of entrepreneurial risk:
  - Fixed rate of return for the state tax credit investor.
  - State tax credit investor had the protection of a blanket tax indemnity for state tax credit risk.

Does your corporation have tax liability in any of the following states?

State	Corporate Tax Credit*
Arizona	Non-Residential Solar & Wind Tax Credit (Corporate)
Arizona	Renewable Energy Production Tax Credit (Corporate)
Arizona	Renewable Energy Tax Credit for Manufacturers (Corporate)
Colorado	EZ Investment Tax Credit Refund for Renewable Energy Projects
Florida	Renewable Energy Production Tax Credit

**See http://www.dsireusa.org/*

Does your corporation have tax liability in any of the following states? (continued)

State	Corporate Tax Credit
Hawaii	Solar and Wind Energy Credit (Corporate)
Iowa	Renewable Energy Production Tax Credits (Corporate)
Iowa	Solar Energy Systems Tax Credit (Corporate)
Kentucky	Energy Efficiency Tax Credits (Corporate)
Kentucky	Renewable Energy Tax Credit (Corporate)
Kentucky	Tax Credits for Renewable Energy Facilities
Louisiana	Tax Credit for Solar Energy Systems on Residential Property (Corporate)

Does your corporation have tax liability in any of the following states? (continued)

State	Corporate Tax Credit
Maryland	Clean Energy Production Tax Credit (Corporate)
Maryland	Bio-Heating Oil Tax Credit (Corporate)
Maryland	Bio-Heating Oil Tax Credit (Corporate)
Missouri	Wood Energy Production Credit
Montana	Alternative Energy Investment Tax Credit (Corporate)
North Carolina	Renewable Energy Tax Credit (Corporate)
North Dakota	Renewable Energy Tax Credit
Nebraska	Renewable Energy Tax Credit (Corporate)

Does your corporation have tax liability in any of the following states? (continued)

State	Corporate Tax Credit
New Mexico	Renewable Energy Production Tax Credit (Corporate)
New Mexico	Sustainable Building Tax Credit (Corporate)
New Mexico	Advanced Energy Tax Credit (Corporate)
New Mexico	Geothermal Heat Pump Tax Credit (Corporate)
New Mexico	Agricultural Biomass Income Tax Credit (Corporate)
New York	Refundable Clean Heating Fuel Tax Credit (Corporate)

Does your corporation have tax liability in any of the following states? (continued)

State	Corporate Tax Credit
Oklahoma	Zero-Emission Facilities Production Tax Credit
Oklahoma	Energy Efficient Residential Construction Tax Credit (Corporate)
Oregon	Biomass Producer or Collector Tax Credit
Oregon	Energy Conservation Tax Credits – Competitively-Selected Projects (Corporate)
Oregon	Energy Conservation Tax Credits – Small Premium Projects (Corporate)
Rhode Island	Residential Renewable Energy Tax Credit (Corporate)

Does your corporation have tax liability in any of the following states? (continued)

State	Corporate Tax Credit
South Carolina	Solar Energy and Small Hydropower Tax Credit (Corporate)
South Carolina	Biomass Energy Tax Credit (Corporate)
Tennessee	Green Energy Supply Chain Franchise and Excise Tax Credit
Utah	Renewable Energy Systems Tax Credit (Corporate)
Utah	Alternative Energy Development Incentive (Corporate)
Wisconsin	Woody Biomass Harvesting and Processing Tax Credit (Corporate)

Drill Down on Louisiana's Residential Solar Tax Credit

- Residential solar photovoltaic systems leased by the Taxpayer to a home owner.
- Credit is "Refundable" so Solar Companies do not need State Tax Credit Investors.
- Credit is 30% with a limit of credit size of $4,560 and a system cost of $2 per watt for the cost of the solar equipment and its installation.
- The system must be purchased before January 1, 2018.
- Program is limited $10 million of credits in fiscal years 2016 and 2017 and $5 million in fiscal year 2018.
  - Credits are awarded on a first come, first served basis.
  - Once the cap is hit, remaining taxpayers' credits roll to the next year.

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David K. Burton is a partner in Mayer Brown's New York office and a member of the Tax Transactions & Consulting practice. He leads Mayer Brown's Renewable Energy group in New York. He advises clients on a wide range of US tax matters, with a particular emphasis on project finance and energy transactions. In addition, he also advises clients on tax matters regarding the formation and structuring of domestic and offshore investment funds.

David has extensive experience structuring tax-efficient transactions, such as sale-leasebacks, flip partnerships, pass-through leases and other structures, for the acquisition and financing of renewable energy assets.
Earlier in his career, David was the managing director and senior tax counsel at GE Energy Financial Services (GE EFS), one of the world's leading investors in energy projects. At GE EFS, David oversaw all of the tax aspects for more than $21 billion in global energy projects from structuring transactions to accounting for taxes to formulating tax policy initiatives. During his tenure at GE EFS, the division's investments in wind, solar, hydro, biomass and geothermal power grew to $6 billion, making GE EFS the largest tax-advantaged energy investor in the US. Before joining GE EFS, David was a tax lawyer at GE Capital and primarily focused on aircraft and equipment leasing and financing and asset acquisitions.

David has been recognized by *Chambers USA* 2015 in the area of Projects: Renewables & Alternative Energy. He was also quoted in *North American WindPower*'s article "Is Treasury More Closely Scrutinizing Cash-Grant Applications" and in the *Power Finance & Risk* article "YieldCo Sweep." He is also quoted in *North American WindPower*'s article "IRS Provides Certainty For Wind Developers To Move Forward With PTC-Eligible Projects."

David received his BA *magna cum laude* from Ithaca College in 1993 and his JD *cum laude* from the Georgetown University Law Center in 1996, where he was on the staff of *The Tax Lawyer*.