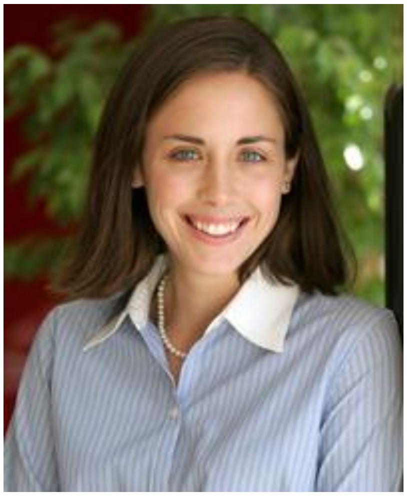
Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Your Energy Tax Credit May Not Be Safe

Law360, New York (January 20, 2015, 11:20 AM ET) --


Jennifer A. Ray

In a decision released on Jan. 12, 2015, the Court of Federal Claims held that a biomass cogeneration plant was entitled to only a fraction of its expected incentive grant under the American Recovery and Reinvestment Act of 2009 (ARRA). W.E. Partners II LLC v. United States, No. 13-54 (Fed. Cl. Jan. 12, 2015).

WEP II constructed and operated an open-loop biomass facility next to a Perdue chicken rendering plant. The facility used three boilers to burn biomass — including forest products waste and agricultural residue — to create steam. The steam from all three boilers then passed through a steam-turbine generator to produce electricity before it passed into the chicken plant to process the chicken.

WEP II applied for a Treasury grant under ARRA Section 1603 for the total cost of the facility. Treasury allowed only about one-third of the amount claimed on the basis that the facility was used for both electricity generation and industrial purposes. Relying on a report by the National Renewable Energy Laboratory that analyzed the heat necessary to drive the steam turbine alone, Treasury determined that one of the facility's boilers would have been sufficient to generate all of the electricity. Accordingly, Treasury denied the grant with respect to the cost of the two boilers that it believed were allocable to a collateral activity: processing chicken. The court agreed with Treasury.

The effect of the court's holding is that only biomass facilities used entirely for production of electricity (power generation facilities) may qualify for an ARRA grant based on the full cost of the facility. A cogeneration facility — even one using no fuel other than biomass — will only qualify for a grant based on only a portion of the cost. Although the court's decision involved the ARRA grant, it also has potential implications for applicability of the investment tax credit for these facilities.

A brief discussion of the background of the ARRA grants is important to understanding the court's decision, why it may be wrong, and the implications.

Background

ARRA provided for new tax incentives for certain qualified energy facilities producing electricity from unconventional fuel sources, including wind, biomass and geothermal energy. ARRA allowed businesses constructing qualified energy facilities to choose between the Internal Revenue Code Section 45 production tax credit, the Internal Revenue Code Section 48 investment tax credit (ITC), or a cash grant from Treasury under ARRA Section 1603(a). Both the ITC and the Section 1603 grant are calculated based on 30 percent of the cost basis of the qualified energy property.

An open-loop biomass facility creates power from agricultural livestock waste, wood from forest waste and waste from other agricultural sources. Such a facility can operate either by co-firing biomass with fossil fuels or by directly firing biomass alone. Any open-loop biomass facility — whether cogeneration or power generation and whether co-firing or direct firing — could qualify for either the ITC or the Section 1603 grant.

Specifically, Internal Revenue Code Section 48(a)(5) provides a credit for “qualified property” that is part of a “qualified investment credit facility.” “Qualified property” includes tangible personal property and other tangible property (not including a building or its structural components) that is used as an integral part of the qualified investment credit facility, in each case that meets certain other requirements. In turn, “qualified investment credit facility” includes open-loop biomass facilities. Neither statutory definition limits qualifying property to facilities burning 100 percent biomass or facilities that are used only to produce electricity.

WEP II

The facility at issue in WEP II was a direct firing facility, so 100 percent of the electricity it generated was produced using biomass. Nevertheless, Treasury reduced the claimed ARRA grants for two reasons. First, Treasury took the position that the components of the WEP II facility were not all qualified property because WEP II was primarily a steam facility and included boilers not necessary for the production of electricity.

Second, Treasury argued that only a portion of the facility’s basis was eligible to be taken into account for purposes of the Section 1603 grant. Generally, the basis of property is its cost. However, Treasury issued “guidance” with respect to the Section 1603 grants taking the position that only “eligible basis” of a qualified facility is counted for purposes of determining the Section 1603 grant.

Specifically, Treasury’s guidance states that the eligible basis (with respect to which the Section 1603 grant would be calculated) “does not include the portion of the cost of the facility that is attributable to a nonqualifying activity.” The guidance provides as an example a co-firing biomass plant that burns fossil fuel in addition to biomass. In that case, the guidance provides that the eligible cost basis is the percentage of total eligible costs multiplied by the percentage of electricity produced at the facility that is attributable to biomass. Costs that relate to both a nonqualifying activity and a qualifying activity must be allocated between those activities. For example, if a facility burns both biomass and coal, and 50 percent of the electricity produced is attributable to each of the biomass and coal, only 50 percent of the facility costs would be eligible for the grant.

Because Treasury relied upon its guidance when ruling on WEP II’s grant application, the court’s opinion begins with a discussion of the level of deference to be afforded to the guidance. Applying Chevron USA Inc. v. Natural Resources Defense Council Inc., the court concludes that the statute, Section 1603, is ambiguous with respect to determining the eligible cost basis of a project.

However, the court also concluded that the Treasury guidance was not entitled to Chevron deference because it was not the product of formal rulemaking. Instead, the court determined that the Treasury guidance, in particular, was entitled to deference under Skidmore v. Swift & Co. Skidmore deference may be afforded to an agency's informal guidance based on the guidance's power to persuade. Here the court concluded that the Treasury guidance was entitled to "considerable weight." Indeed, as discussed below, the informal guidance supplied the rule of decision in this case.

Turning to the arguments, the court rejected Treasury's position that all three boilers were not qualified property. It held that WEP II was a qualifying facility and furthermore that all of its boilers were qualified property because they were all used to produce steam that went through the steam turbine generator. In this portion of the analysis, the court appears to conclude that all three boilers are "integral" to the qualified facility, within the meaning of Section 48, because all three boilers were actually involved in making electricity. It was irrelevant that WEP II could have created the same amount of electricity with fewer boilers. This holding confirms that an open-loop biomass facility can be qualified property regardless of whether it is a cogeneration facility or a pure power generation facility, and regardless of whether it is co-firing or direct firing.

When it came to Treasury's allocation of basis argument, however, the court relied on Treasury's guidance to cut back to the amount of the ARRA grant. In this portion of the analysis, the court quotes the reasonable allocation of basis rule from the guidance (discussed above) as the rule of decision. It then goes on to conclude that Treasury acted reasonably in using the NREL study of the minimum steam required to drive the steam turbine as a basis for allocating the cost of two of the three boilers to "nonqualifying activities."

Although the Treasury guidance does not discuss cogeneration facilities (but rather focuses on the difference between co-firing and direct-firing plants), the court essentially held that providing steam to the chicken plant was a "nonqualifying activity" within the meaning of the Treasury guidance. The court did not cite any authority for this proposition. One possible theory for the court's holding is that the Section 45 production tax credit is available only for electricity produced using biomass.

However, the ARRA grant is not based on the Section 45 production tax credit but rather on the Section 48 ITC. In general, Section 48 does not limit the uses of power generated by the qualified property. Rather, it focuses on use of unconventional fuel to produce power. Under the statutory scheme, the cost of an open-loop biomass facility should qualify for the Section 48 ITC (and therefore the ARRA grant) regardless of whether it is a cogeneration facility or a power generation facility.

Moreover, the court's holding is not supported by the ITC regulations. Treasury and the IRS have not issued regulations with respect to the modern energy ITC, but Notice 2008-68 refers to Treasury Regulations Sections 1.46-3(a) and (c) to determine eligible basis for the ITC. Those regulations provide that the applicable basis is cost, without any suggestion that basis should be allocated to "nonqualifying activities."

The Section 48 regulations promulgated for previous versions of the energy credit do contain a concept that in certain cases, basis must be allocated between qualified property and other property. For example, if a facility has more than one "significant purpose," only the incremental cost attributable to performing the qualifying function is eligible for the ITC. Those regulations apply only to specific types of property listed therein, not including biomass facilities.

Implications for Investment Tax Credit

WEP II is of limited relevance with respect to Section 1603 grants, because the deadline for submitting applications was Oct. 1, 2012. However, as discussed above, the criteria for Section 1603 grants are almost identical to the criteria for the Section 48 ITC. Thus, the case is highly relevant to taxpayers planning to use ITC to finance certain kinds of energy property. It is possible that the IRS will use this case to argue that, for example, the ITC is not available for all of the costs of building an open-loop biomass cogeneration facility, even though no such restriction appears in the Internal Revenue Code, regulations or IRS guidance with respect to Section 48. Businesses should consider this potential risk when financing energy projects.

—By Jennifer A. Ray and David B. Blair, Crowell & Moring LLP

Jennifer Ray and David Blair are Washington, D.C.-based partners in Crowell & Moring's tax group.