

Energy Tax Highlights from the Economic Rescue Act

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For those in the renewable energy industry, Congress' adoption of the economic rescue act carried with it a huge unexpected dividend. Division B of that law (entitled the Energy Improvement and Extension Act of 2008, the "Energy Act") finally adopted an extension and expansion of the tax incentives for renewable energy projects (and a host of related tax incentives for energy development), which had been stymied in Congress for the last ten months.

Since December 2007, repeated efforts to renew the expiring tax incentives for renewable energy source development had failed. The principal cause had been stubborn differences between the parties over the issue of whether the tax cost of renewal should be offset by "revenue raisers," with House Democrats insisting on that position and Senate Republicans objecting.

Unexpectedly, a last-minute addition to the economic rescue act was the Senate provisions on renewable incentive extenders (and related energy incentives). These were only partially offset with revenue increase provisions. They also did **not** include a new 35 percent-of-cost present-value cap on production tax credits for renewable energy facilities (which had been a component of the House version of the "extenders" legislation).

The scope of these provisions is so broad and varied as to preclude any attempt at a brief summary. This article will instead mention only some significant highlights.

Renewable Energy Source Incentives

Principal among these is an extension of the production tax credits (PTCs) under Internal Revenue Code section 45, for renewable energy facilities—credits which were otherwise due to expire at the end of this year. As extended, the credits apply to wind and refined coal facilities placed in service before January 1, 2010, and to qualified open- and closed-loop biomass, geothermal and solar, small irrigation, landfill gas, trash combustion and qualified hydropower facilities in service before January 1, 2011. Newly added are qualified marine and hydrokinetic power facilities, which operate on tidal and other naturally occurring water energy.

These extensions are critical to the industries affected, since the PTCs are essential to the economics of projects using these technologies. Unfortunately, the relatively brief extensions will not accommodate longer-term projects, and the advocates for these technologies will need to return to Congress shortly for further extensions. In addition, since financial institutions have been significant investors in the tax benefits from these transactions, it is not yet clear whether the troubled condition of those parties may limit the helpful effect of these now-renewed incentives.

By contrast, the solar energy and fuel cell industries were big winners—securing an eight-year extension of the 30 percent investment tax credit for such properties, and an increase in the fuel cell credit limit from \$500 to \$1,500 per half-kilowatt of electric generating capacity of such plants. In addition, the exclusion for public utility property was removed, and the credit may now be used against the alternative minimum tax (AMT). These changes should be a major boost to the long-term planning and development of large-scale projects of this type.

Investment credits were also added for qualifying moderate-sized combined-heat-and-power (cogeneration) systems, and for small wind and geothermal heat pump systems. And the credits for residential energy efficient property were extended for eight years, with the annual limit on the credit for solar electric property being removed.

An additional \$800 million of "clean renewable energy bonds" were authorized to finance qualifying renewable energy facilities for governmental, public power and electric cooperative entities. And the credit

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for refined coal facilities was expanded to cover a new category, specially defined as “steel industry fuel.”

Qualified Advanced Coal Project Credit

Internal Revenue Code section 48A provides for a 20 percent investment tax credit on qualified investments in integrated gasification combined cycle (“IGCC”) projects and a 15 percent investment tax credit on qualified investments in other advanced coal-based generation technologies. Taxpayers must apply for an allocation of the credits from the Treasury Department during a designated application period, with aggregate credits to be awarded capped at \$800 million for IGCC projects and \$500 million for other advanced coal-based generation technologies. The requirements for an allocation of credits include (i) the project must use advanced coal-based technology to power an electrical generation unit, (ii) the fuel input upon completion must be at least 75 percent coal, (iii) the nameplate capacity must be at least 400 megawatts and (iv) the project must be located in the United States. The Energy Act adds a second application period, with an additional \$1.25 billion of tax credits that may be awarded to such projects during that period. The credit is increased to 30 percent for these second-round projects and a requirement is added that projects must separate and sequester at least 65 percent of their carbon dioxide emissions. Priority for awarding credits is given to those projects with the greatest percentage of carbon dioxide separation and sequestration.

Qualifying Gasification Project Credit

Internal Revenue Code section 48B provides for a 20 percent investment tax credit on qualified investments in qualifying gasification projects. Such credits are subject to an application process similar to the section 48A credits, with an aggregate cap of \$350 million on credits which can be awarded. The Energy Act adds a second allocation cap of \$250 million for projects in which a minimum of 75 percent of carbon dioxide emissions are separated and sequestered. The credit percentage for such projects is increased to 30 percent. Priority for awarding credits is given to those projects with the greatest percentage of carbon dioxide separation and sequestration.

Carbon Dioxide Sequestration Credit

The Energy Act adds new Internal Revenue Code section 45Q, which provides for a credit of (i) \$20 per metric ton of qualified carbon dioxide emissions which is captured at a qualified facility and sequestered and (ii) \$10 per metric ton of qualified carbon dioxide emissions which is captured at a qualified facility and

used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. “Qualified carbon dioxide” is carbon dioxide that (A) is captured from an industrial source, (B) would have been released into the atmosphere as an industrial emission of greenhouse gas and (C) is measured at the point of capture and is measured and verified at the point of disposal. A qualified facility is a facility owned by the taxpayer at which carbon capturing equipment is placed in service and which captures a minimum of 500,000 metric tons of carbon dioxide during the taxable year. The credit is available only with respect to the first 75 million metric tons of carbon dioxide that the Environmental Protection Agency certifies has been captured and sequestered in a given calendar year. The amount of the credit is adjusted for inflation annually for taxable years after 2009.

Transportation-Related Incentives

The Energy Act includes provisions for expanding and extending the existing credits for the production of biomass ethanol and other alternative fuels, and other transportation-related credits. It also adopts an interesting new credit for the purchase of qualified electric plug-in vehicles.

The credit appears to be up to \$7,500 for normal passenger vehicles, and higher amounts for heavier vehicles. The vehicle must meet certain technical performance standards. The credit phases out in stages after the sale of more than 250,000 such vehicles in the United States. This seems to be an important stimulus for the production and sale of vehicles of this type.

Conservation-Related Incentives

The Energy Act adds a number of tax incentives for energy conservation property. Notable among these is a new authorization of up to \$800 million of “Qualified Energy Conservation Bonds.”

Like the new Clean Renewable Energy Bonds (“CREBs”) also authorized by the Energy Act, these are state or local bonds that entitle the holder to a federal tax credit, in lieu of interest. Also like the new CREBs, the credit is limited to 70 percent of the amount that would otherwise be determined under Internal Revenue Code section 54A(b). The latter is the amount determined by the Secretary of the Treasury as sufficient to enable the bonds to be sold without a discount, and without provision for interest. Thus, it appears that the federal subsidy for these bonds is only partial, and that they will need to be sold at a discount or provide for some amount of interest, or both.

The total authorized amount of bonds is to be allocated among the states in proportion to their population, and within states to “large” local governments in proportion to their population. The permitted purposes include the financing of renewable energy facilities for which production credits are allowable (with a few exceptions) and a host of other energy conservation projects, research or improvements.

While this is an interesting initiative, the allocation process seems likely to fragment the allowable bond amount significantly. It also is not yet clear that the tax credit bond concept is completely workable.

Revenue Raisers

As a partial offset to the projected revenue cost of the energy tax incentives, the Energy Act included a short list of revenue-raising measures.

Oil-Related Manufacturing Deduction. The Energy Act effectively reduces the manufacturing deduction under Internal Revenue Code section 199 from nine percent to six percent for domestic oil-related production activities. This was a compromise, as compared with earlier proposals to deny or more sharply reduce this deduction for major oil companies.

Foreign Oil-Related Income. In another anti-oil company provision, the Energy Act requires the limitation on foreign tax credits to be computed on a combined basis for foreign oil extraction income and other foreign

oil-related income, rather than separately (as at present). Thus, a loss in one such category will now reduce the tax credits allowable for taxes on the other.

Broker Reporting of Customer’s Basis in Securities Transactions. Brokers who are required to make a return under Internal Revenue Code section 6045(a) with respect to the gross proceeds of the sale of publicly traded securities, such as stock, debts, commodities, derivatives and other items specified by the Treasury, shall include the customer’s adjusted basis in such security (determined in accordance with the first-in, first-out (FIFO) method unless the customer notifies the broker otherwise) and whether any gain or loss recognized is short-term or long-term.

0.2% FUTA Surtax. The Federal Unemployment Tax Act (FUTA) imposes a 6.2% gross tax rate on the first \$7,000 paid annually by covered employers to each employee. In 1976, Congress passed a temporary surtax of 0.2% to the permanent FUTA tax rate. Since then, the temporary surtax has been extended each year. This legislation extends it another year through 2009.

Material Available On-Line

The following material is available with the indicated file sizes:

- **H.R. 1424, Division B**, the Energy Improvement and Extension Act of 2008 [164K].

Offshore Deferred Compensation to be Taxable at Time of Vesting

Clare Stoudt • Nicholeen DePersis

On October 3, 2008, the economic rescue act¹ was enacted with the hope of restoring the viability of the nation’s credit markets. Division C of this act, entitled the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, contains a revenue-raiser requiring the current income inclusion upon vesting of nonqualified deferred compensation paid by certain “tax indifferent” entities, effective for services performed beginning January 1, 2009.

Deferred compensation attributable to services provided prior to January 1, 2009, is entitled to up to a ten-year grandfather provision; thus deferred

compensation that would be payable in 2018 or later may be deferred only through 2017 (or until no longer subject to a substantial risk of forfeiture, if later). The new provision “is tougher than tax provisions for nonqualified deferred compensation under tax code section 409A,” according to an Internal Revenue Service

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¹ H.R. 1424.

official.² Under the new provision, offshore nonqualified deferred compensation will be taxed when it becomes vested, “even if it is only an unfunded, unsecured promise to pay.”³

Background

The tax treatment of nonqualified deferred compensation is currently governed by section 409A of the Internal Revenue Code (the “Code”). Generally, if certain requirements are met, deferred compensation is not taxed until actually or constructively received. The service recipient is not permitted a deduction for the nonqualified deferred compensation until the taxable year in which the deferred compensation is includible in the service provider’s income. The deduction deferral creates a “tension” between a service provider and a taxable service recipient, potentially limiting the amount of compensation the service recipient is willing to permit the service provider to defer.

If, however, the service recipient is indifferent to the timing of the deduction, (as in the case of a service recipient not subject to U.S. taxation) “the cost of allowing service providers to defer under a nonqualified deferred compensation arrangement is not borne by the service recipient. Instead, this cost is borne by the Treasury.”⁴

Though only recently passed, legislation to remedy the issue of using tax-indifferent parties for deferred compensation plans was originally introduced in 2007, the Offshore Deferred Compensation Reform Act of 2007.⁵ When the Offshore Deferred Compensation Reform Act did not pass, the legislation continued to be proposed as part of other reform efforts, most recently in the Energy Improvement and Extension Act of 2008.⁶

New Code Section 457A

New Code section 457A requires the current inclusion of amounts deferred under a nonqualified deferred compensation plan of a “nonqualified entity,” when such amount is no longer subject to a substantial risk of forfeiture. Compensation is not treated as deferred if it

is received by the service provider within 12 months after the end of the service recipient’s taxable year in which the compensation is no longer subject to a substantial risk of forfeiture. For purposes of the provision, a nonqualified entity is any foreign corporation unless substantially all its income is effectively connected with the conduct of a trade or business in the United States or its income is subject to a comprehensive foreign income tax.⁷ A nonqualified entity is also a partnership unless substantially all of its income is allocated to persons other than foreign persons or tax-exempt persons.

Under Code section 457A, a nonqualified deferred compensation plan is defined by reference to Code section 409A. However, plans that provide a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient are also nonqualified deferred compensation plans for purposes of the new Code section 457A. Thus, the new provisions may not apply to equity interests in a fund (such as carried interests, restricted stock and options) but would apply to stock appreciation rights and other types of awards based on the appreciation in the value of the fund or its equity units.

If the amount of the compensation is not determinable, that amount will be includible at the time it becomes determinable, but will be subject to interest computed back to the year in which the compensation was earned or released from a substantial risk of forfeiture, if later, along with a 20 percent penalty at the time of income inclusion.

Compensation determined solely by reference to the gain recognized on disposition of an investment asset is excepted from the rule. In such cases, the nonqualified deferred compensation is treated as subject to substantial risk of forfeiture until the time of the disposition of the asset, and therefore is not includible until the time of disposition.

Who Is Affected By 457A?

Code section 457A impacts any person deferring compensation under the nonqualified plan of a “nonqualified entity,” as defined above. The provision was specifically designed to reach U.S. managers of offshore hedge funds, including those with side pocket investments or foreign and tax-exempt investors. Typically, fund managers may elect to defer the fees they earn from providing investment advice to funds, and because the offshore funds are not subject to U.S.

² Alan Tawshunsky, Deputy Division Counsel and Deputy Associate Chief Counsel in the Internal Revenue Service’s Tax Exempt and Government Entities Division, speaking at an October 3, 2008 American Law Institute-American Bar Association Conference.

³ *Id.*

⁴ H.Rpt. 110-658, 110th Cong., 2nd Sess. (accompanying H.R. 6049), p. 195.

⁵ S. 2199.

⁶ H.R. 6049.

⁷ Code § 457A(b)(1)(A), (B).

taxation (and therefore indifferent to the timing of the deduction for the payment of compensation), there is no incentive for the fund to restrict the amount of that deferral. New section 457A makes that compensation taxable to U.S. fund managers as soon as it is no longer subject to substantial risk of forfeiture.

Further, the carried interest in hedge funds and equity funds could be subject to the new provision to the extent that the carry represents a right to compensation. Whether the carry would be treated as compensation is not clear; however, the terms and structural assumptions of fund agreements should be reviewed in light of the new law.

Although the target of new Code section 457A is deferred compensation paid by offshore hedge funds, any partnerships with foreign partners or tax-exempt investors could potentially be subject to the provision. Accordingly, such partnerships should review any plan that allows for the deferral of compensation to determine whether the new law applies.

The statute focuses on deferred compensation maintained by a foreign corporation in countries with

minimal income tax, such as Bermuda or the Cayman Islands, or by a foreign or U.S. partnership in which the partners are not subject to U.S. or foreign income tax or where a significant equity interest is held by a tax exempt entity. Issues are raised where a U.S. taxpayer works for a nonqualified entity both within and without a covered jurisdiction, or works in a tax treaty jurisdiction but is covered by a plan maintained in a covered jurisdiction. Taxpayers should consider what compensation alternatives are available in light of new section 457A.

Material Available On-Line

The following material is available with the indicated file sizes:

- [H.R. 1424, Division C, Title VIII, § 801](#), enacting new Code § 457A [41K].
- [H.R. 6049, § 401](#), an earlier version of § 457A, passed by the House in May 2008 [43K].
- [H.Rpt. 110-685, pp. 187-199](#), accompanying H.R 6049 [101K].

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