

THE LAW OF LAVA
—Getting Some Credit:
Tax Issues—

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The tax system often is used to provide incentives for particular types of investments that the government wants to encourage. These incentives raise tax planning issues that go well beyond those involved in general structural, choice-of-entity, and other financing considerations, and create the potential for significant economic benefit. The available incentives also have been subject to frequent changes as federal and state energy policies have evolved. The following discussion is only a general summary and is current as of the date shown above. Please contact one of the attorneys listed above for answers to your specific legal questions and to check on any changes that may have occurred since the date of this publication.

I. Federal Income Tax Issues.

A. The Production Tax Credit. Section 45 of the Internal Revenue Code of 1986, as amended (“Code”), provides a credit against federal income tax for electricity produced from certain renewable resources, including geothermal. This credit is known as the “production tax credit” (“PTC”).

1. Requirements for Claiming the Credit. The PTC for geothermal power applies to electricity that is (1) produced at a qualified facility during the 10-year period that begins on the date the facility was originally placed in service and (2) sold to an unrelated person during the taxable year. Each of the following requirements must be satisfied for a taxpayer to claim the PTC:

a. Produced by the Taxpayer. The electricity must be produced by the taxpayer seeking to claim the PTC. If more than one person has an ownership interest in a facility, production from the facility is allocated among the owners in proportion to their respective ownership interests in gross sales from the facility. A partnership (including an LLC that is taxed as a partnership) is treated as one person for purposes of this rule, which means that individual partners are not treated as owning separate undivided portions of a facility owned by a partnership.

b. Qualified Energy Resources. The electricity must be produced from a geothermal deposit. A geothermal deposit is defined as a geothermal reservoir consisting of natural heat that is stored in rocks or in aqueous liquid or vapor, whether or not under pressure.

c. Qualified Facility. The electricity must be produced by a facility located in the United States that is owned by the taxpayer claiming the PTC and that was originally placed in service after October 22, 2004 and before January 1, 2014. A facility generally is considered to be “placed in service” for purposes of this rule when it is placed in a condition or state of readiness and is available to produce commercial quantities of electricity.

d. Sold by the Taxpayer. The electricity must be sold by the taxpayer claiming the PTC to an unrelated person during the taxable year.

e. No Advance Approval Required. There is no advance approval requirement for claiming the PTC. A taxpayer that is entitled to the credit simply reports it on the appropriate form attached to the taxpayer’s federal income tax return.

2. Calculation of the PTC. The PTC for any taxable year during the credit period generally is equal to 1.5 cents, adjusted for inflation, multiplied by the number of qualified kilowatt hours of electricity produced and sold by the taxpayer during the year. For electricity produced and sold during 2009, the inflation-adjusted PTC amount was 2.1 cents per kilowatt hour.

3. **Cutback for Government Financing.** The amount of the PTC is reduced for facilities financed in whole or in part with certain government grants, proceeds of tax-exempt bonds, subsidized energy financing (financing provided under a federal, state, or local program designed to provide subsidized financing for energy conservation projects), or other tax credits. The IRS has ruled that certain state tax credits do not reduce the PTC.

4. **Nonrefundable Credit.** The PTC is a “nonrefundable” credit. If a taxpayer entitled to the PTC does not have sufficient income tax liability to use the entire credit for a particular year, the taxpayer is not entitled to a refund of federal income tax on account of any excess credit. Any unused portion of the credit generally may first be carried back one tax year and then forward 20 tax years from the year the credit arose.

5. **Sunset Date.** To qualify for the PTC, a facility must be originally placed in service before January 1, 2014. The sunset date has been extended a number of times since section 45 was first added to the Code (once retroactively after the PTC had expired for a number of months). Most recently, the American Recovery and Reinvestment Tax Act of 2009 extended the sunset date to January 1, 2014. Proposals to extend the sunset date are a matter of frequent discussion, and it is possible that the sunset date could be extended beyond January 1, 2014 by future legislation.

B. The Investment Tax Credit. The owner of a qualified geothermal facility may claim the investment tax credit (“ITC”) in lieu of the PTC. The ITC is a one-time credit against income tax that is based on the amount invested in a facility rather than on the amount of electricity produced and sold. The amount of the ITC for a qualified geothermal facility placed in service from 2009 through 2013 is 30 percent of the tax basis (generally the cost) of the qualifying property. The amount of the ITC for a geothermal facility placed in service after 2013 is 10 percent of the tax basis of the qualifying property.

1. **Requirements for Claiming the ITC.** The ITC applies only to “energy property,” which is defined for purposes of a geothermal facility to include only property that meets the following requirements:

a. **Geothermal Equipment.** The property must be equipment that is used to produce electricity from a geothermal deposit. The property must be (1) tangible personal property or (2) other tangible property (not including a building or its structural components) that is an integral part of the geothermal facility.

b. **Depreciable or Amortizable.** The property must be eligible for depreciation or amortization deductions for federal income tax purposes.

c. **Irrevocable Election for 30% Credit.** The owner of the property must make an irrevocable election to claim the ITC rather than the PTC for property that is placed in service from 2009 through 2013.

2. **Progress Expenditure Rules.** In certain circumstances involving qualified energy property with a normal construction period of more than two years, a taxpayer may be entitled to claim the energy credit with respect to progress expenditures in tax years before the property is placed in service.

3. **Basis Reduction.** The tax basis of property with respect to which the ITC is claimed is reduced for all tax purposes (including depreciation and calculating gain from a sale) by one-half of the amount of

the credit. Thus, the tax basis of the qualifying components of a geothermal facility with respect to which the 30 percent ITC is claimed generally will be 85% of the cost of those components.

4. **Recapture of the Credit.** The ITC is subject to recapture if, within five years after a facility is placed in service, the taxpayer sells or otherwise disposes of the energy property or stops using it in a manner that qualifies for the credit. The amount of recapture depends on when during the five-year period the property is disposed of or ceases to be used in a qualifying manner.

5. **No Cutback for Government Financing.** The ITC for a geothermal project, unlike the PTC, generally is not reduced with respect to facilities that are financed in whole or in part with the proceeds of tax-exempt bonds, subsidized energy financing, or other forms of government-supported financing.

6. **Nonrefundable Credit.** The ITC, like the PTC, is a nonrefundable credit. If a taxpayer entitled to the ITC does not have sufficient income tax liability to use the entire credit for a particular year, the taxpayer is not entitled to a refund of federal income tax on account of the credit. Any unused portion of the credit generally may be carried first back one tax year and then forward 20 tax years from the year the credit arose.

7. **Sunset Date.** To qualify for the 30 percent ITC, a facility must be placed in service after December 31, 2008 and before January 1, 2014. There is no sunset date for the 10 percent ITC for geothermal facilities.

C. **U.S. Treasury Department Grants.** The American Recovery and Reinvestment Act of 2009 allows the owner of a qualified geothermal facility that is eligible for the ITC (including by reason of an election to claim the ITC rather than the PTC) to elect to receive a grant from the U.S. Treasury Department in lieu of claiming the ITC or the PTC with respect to the facility. The grant generally is designed to function in the same manner as the ITC for which the owner of a project otherwise would have been eligible.

1. **Qualification for Grant.** To qualify for a grant, a geothermal project must (i) qualify for the ITC and (ii) be placed in service during 2009 or 2010 or, if construction is begun in 2009 or 2010, be placed in service on or before January 1, 2013.

2. **Amount of Grant.** Like the ITC, the amount of the grant generally is 30% of the tax basis (generally the cost) of qualifying property.

3. **Excluded from Income.** A grant is not included in the taxable income of the recipient.

4. **Basis Reduction.** The tax basis of the property is reduced by one-half of the amount of the grant, in the same manner as if the ITC were claimed.

5. **Recapture.** A grant generally is subject to recapture if, within five years after a facility is placed in service, the recipient stops using it in a manner that qualifies for the grant or sells or otherwise disposes of the property to a person who would not have been eligible for the grant if that person had originally placed the property in service.

6. **No ITC or PTC Allowed.** No ITC or PTC may be claimed with respect to property for which a grant has been claimed.

7. **Timing of Payment.** The U.S. Treasury Department is required to pay a grant to a qualifying project owner within 60 days after the date the project owner applies for payment or the date the facility is placed in service, whichever is later.

8. **Application Deadline.** An application for the grant must be filed before October 1, 2011.

D. Bonus Depreciation and MACRS Depreciation. In addition to tax credits or grant payments, geothermal facilities also can generate significant tax losses that can be quite valuable to owners with other sources of taxable income that can be offset by the losses. These losses result primarily from bonus depreciation and accelerated depreciation deductions under the modified accelerated cost recovery system (“MACRS”).

1. **Bonus Depreciation.** An owner of qualifying property placed in service in 2009 is entitled to deduct 50% of the adjusted basis of the property in 2009. The remaining 50% of the adjusted basis of the property is depreciated over the regular tax depreciation schedule.

2. **MACRS Depreciation.** Qualifying components of a geothermal facility also are eligible for greatly accelerated depreciation deductions, typically over a five-year period based on the double declining balance method.

E. Federal Election to Deduct Intangible Drilling and Development Costs. Section 263(c) of the Code authorizes a taxpayer to elect to deduct currently, rather than capitalize and depreciate or amortize, certain intangible drilling and development costs related to exploration for, and development of, a geothermal deposit. The benefit of this election may be decreased by a special rule limiting the amount of certain corporate preference items. In addition, making the election may have alternative minimum tax consequences. Nevertheless, currently deducting a portion of these expenditures can result in significant tax savings as compared to depreciation or amortization. The potential deduction for intangible drilling and development costs should be carefully analyzed in any transaction in which a developer wishes to monetize tax credits associated with the resulting geothermal facility. Because intangible drilling costs arise before a project is constructed or placed in service and such benefits cannot be transferred to a tax investor after they have become available, it may be necessary to monetize these benefits during development and separately from depreciation and credits applicable to the geothermal facility.

F. Monetizing Federal Income Tax Benefits; Ownership Structuring Issues. A taxpayer that has little or no need for tax credits or losses (*e.g.*, because it has little or no taxable income) may nevertheless be able to obtain the benefit of various tax incentives by entering into an arrangement with an investor that needs credits, losses, or both. For example, a taxpayer could enter into a partnership with an investor that is willing to contribute cash to help finance a geothermal facility. The partnership could then operate the facility and, within certain limits, the tax credits and losses could be allocated to the partner having a need for them. In the alternative, a taxpayer could develop a facility, place it in service, sell it to an investor, and then lease it back from the investor. This second alternative, known as a “sale-leaseback,” is available with respect to the ITC and the grant, but generally is not available with respect to the PTC. These and other potential techniques for “monetizing” tax credits and losses involve risk and require careful tax planning. These considerations should be taken into account in the very early stages of a project, including when choosing the type of entity that will own a facility and the various financing alternatives available. The grant in lieu of the ITC provides a new financing option for developers of geothermal facilities to consider. Even developers that opt for the grant, however, may still desire to involve tax-motivated investors to take advantage of the accelerated depreciation and other tax

benefits associated with a project. A comparison of the economic benefits of the PTC, the ITC, and the grants requires, among other considerations, careful financial modeling of the projected costs and output of each specific project and of the full array of potential tax and financing implications. This should include careful consideration of any limitations that may apply to a particular owner's ability to claim the available tax benefits, such as alternative minimum tax liability, at-risk limitations, and passive activity limitations. The unique attributes of geothermal facilities relating to intangible drilling costs and development costs also place a premium on very early planning for financing a geothermal project.

II. State and Local Tax Issues. In addition to federal income tax issues, construction and operation of geothermal facilities also raise numerous state and local tax issues that should be carefully examined. Following is a general description of the types of issues that may arise, with selected examples.

A. Net Income Tax States. The vast majority of states impose a net income tax. States generally base their income tax system on the federal system, and many states have adopted relatively uniform rules governing division of the tax base and computation of taxable income. Despite these similarities, however, each state's tax system is different and must be separately analyzed.

Nexus and Apportionment. Siting a geothermal project in a particular state will create "nexus" with that state and will allow the state to tax the income of the company that owns or operates the project. In addition, less substantial activities, such as consulting in a state, may create nexus.

States generally measure the taxable income of a company by allocation and apportionment. In western states, including California, Idaho, Montana, and Utah, the company's overall business income from all sources is apportioned to the state based on the company's property, payroll, and sales within the state. Reflecting a national trend, Oregon's apportionment is now based entirely on sales. For purposes of apportioning sales of electricity among different states, some states, such as California, source the sale based on where the majority of income-producing activity related to the sale occurs. Other states may use different sourcing rules. Oregon, however, takes the position that sales of electricity are sourced to the state where delivery occurs. The apportionment rules can sometimes produce surprising results: if the company as a whole has taxable income, the company may owe tax to a state even if the activities in that state are not profitable on a stand-alone basis.

Income Tax Incentives. Some income tax states offer incentives to promote the development of geothermal power and other alternative energy projects. It is important to understand the nature of each incentive, as there is considerable variation among the states. Also, as noted above, some state incentives may reduce the amount of the federal energy credit available for the project.

For example, Oregon has adopted a business energy tax credit (the "BETC"). The BETC program allows an Oregon taxpayer that owns and operates a geothermal power project to claim a credit against Oregon income tax to offset the eligible costs of construction of the project. Legislation passed in 2007 substantially increased the amount of the credit. Under the new law, the amount of the credit is 50 percent of the eligible costs, up to a maximum total credit amount of \$10 million (formerly \$3.5 million). The total credit amount is claimed over five years, and unused credit may be carried forward for up to eight years. A developer may sell the BETC outright, at a discount established by the state. Certain other incentives, including federal grants, and potentially including the federal grant in lieu of the PTC or the ITC, may reduce the amount of the BETC. Although the 2009 legislature adopted a bill that would have cut back the BETC for many kinds of projects, the governor vetoed that bill, and the cutbacks did not become law.

Montana offers a somewhat similar income tax credit for certain alternative energy systems, including geothermal systems.

B. Sales and Use Taxes. Nearly all of the states impose a sales tax. In most states, the tax is imposed only on sales of tangible personal property. Some states also impose use tax on sales of certain kinds of services. In addition, some states impose a transfer tax on the sale (and sometimes the lease) of real property.

Purchase or Use of Turbines and Other Equipment. Most states' sales and use taxes will apply to purchases or use of turbines and other equipment within those states.

Generally No Sales or Use Tax on Sales of Power. Most states that impose sales and use taxes do not impose those taxes on sales or use of electricity.

Tax Incentives. Some states, such as Nevada, offer exemptions or other sales and use tax incentives for geothermal energy facilities. Idaho's 2005 legislature adopted a sales and use tax rebate for certain alternative energy generation equipment, including machinery and equipment used in generating electricity from geothermal resources. In 2009 Washington adopted a sales and use tax incentive for certain alternative energy generation equipment, including machinery and equipment used in generating electricity from geothermal resources. The incentive is a 100 percent exemption from July 1, 2009 through June 30, 2011 and a 75 percent rebate from July 1, 2011 through June 30, 2013.

C. Property Tax. Virtually all states impose property tax that is assessed annually and is measured, in some fashion, by the value of real property. Most states also tax tangible personal property that is used for business purposes. Intangible property is taxable in some states if the owner is centrally assessed, as discussed below.

Central Assessment Likely. In many western states, such as Oregon, a company that produces electricity is "centrally assessed" for property tax purposes. Central assessment means that the amount of property tax is determined by the state revenue authority rather than by the county assessor's office. In Washington, central or local assessment depends in part on whether the company's property crosses county lines. In California, the facility's output is a factor in determining whether central assessment applies.

Valuation. States generally accept the three traditional valuation methods for valuing utility property (the cost approach, income approach, and comparable sales approach). Determining the correct value of a particular project is a matter of frequent controversy. It is often useful to consult an expert in the area of utility appraisal.

Property Tax Reporting. States typically require owners of centrally assessed property to file annual returns reporting the value of their property. It is good practice to consult a valuation expert before filing the first return with respect to the property, in order to accurately communicate on the return items that could result in tax savings in future years.

Rollback Penalties in Farm and Timber Use Areas. Some states, such as Oregon, Washington, and California, impose property tax penalties when land that is used for farming or timber is dedicated to a different use. In addition to those penalties, property taxes increase prospectively after the change of use. This issue may arise during the siting process.

Property Tax Incentives. As part of due diligence in constructing or acquiring a geothermal facility, it is worthwhile to inquire whether any property tax incentives are available. Property tax incentives can be

particularly advantageous because, in contrast to income tax credits, a property tax exemption typically applies at the front end of an investment and reduces what otherwise would be an unavoidable and substantial cost. Nevada and Montana, for example, offer a property tax exemption for certain renewable energy facilities, including geothermal energy facilities. Oregon's exemption statute was expanded in 2007 to allow exemption for a greater range of projects when the electricity is used on site. Also in Oregon, it may be possible to obtain a temporary property tax exemption under the state Enterprise Zone Program or the Strategic Investment Program. The Enterprise Zone Program typically offers an exemption for three to five years, but in rural areas the exemption period may be as long as 15 years. To qualify, state law requires that the company increase its permanent, full-time employment within the zone by at least 10 percent. (Note that one employee may satisfy the minimum hiring requirement if the company has not previously operated within the zone.) Other requirements, such as minimum capital investment size, may apply. The Strategic Investment Program statutes offer a partial exemption for 15 years, with a fee payable to the county and other potential conditions. Negotiations for benefits under both the Enterprise Zone and Strategic Investment Programs generally occur at the county level, sometimes with participation of cities.

D. Excise Taxes. When considering operation of a geothermal power facility, state and local excise taxes also should be taken into account.

Washington Public Utility Tax. The state of Washington and a number of municipalities within Washington impose a public utility tax ("PUT") on the privilege of engaging in certain utility businesses within the state and those localities. The state PUT is imposed at a rate of 3.873 percent of gross income derived from certain enumerated public service businesses, including the "light and power business." The "light and power business" is defined for purposes of the state PUT as "the business of operating a plant or system for the generation, production or distribution of electrical energy for hire or sale and/or the wheeling of electricity for others." The state PUT is intended to apply only to revenues derived from the retail sale of electricity to consumers. Accordingly, deductions in computing gross revenues may be allowed for revenues derived from the sale of electricity for resale, among other deductions. The Washington business and occupation tax may also apply, depending on the specific activities that the business conducts. Cities and towns also may impose a local PUT or a local business and occupation tax, or in some circumstances, both. Local rates can be substantial.

Other State and Local Excise Taxes. Other states and localities may impose other kinds of excise taxes. For example, some Nevada counties and cities, and some California cities, impose gross receipts taxes for the privilege of doing business in the locality. California imposes a fee based on gross receipts for the privilege of doing business as a limited liability company.