

LAVA LAW
GETTING SOME CREDIT:
—Tax Issues—

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Production of electricity from geothermal resources raises numerous federal, state, and local tax issues in addition to those involved in general choice-of-entity considerations. These tax issues place a premium on careful structuring, and can create significant economic benefits or can give rise to significant costs.

Federal Production Tax Credit

Section 45 of the Internal Revenue Code of 1986, as amended (the “Code”) provides a credit against income tax, commonly known as the production tax credit (“PTC”), for electricity produced from certain renewable resources. Prior to 2004, the PTC applied only to electricity produced from wind, closed-loop biomass and poultry waste. As part of the American Jobs Creation Act of 2004, however, Congress extended the PTC to apply to geothermal facilities. This extension of the PTC significantly expanded and improved the financing alternatives available for geothermal facilities.

Requirements for Claiming the PTC

The PTC is based on production, rather than the cost of a facility. The PTC applies to electricity produced by a taxpayer from qualified energy resources at a qualified facility and sold to an unrelated person during any taxable year in the credit period. Each of the following requirements must be satisfied for a taxpayer to claim the PTC:

- *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 the gross sales from the facility.
- *Qualified Energy Resources.* The electricity must be produced from energy derived from a geothermal deposit, which is defined as a geothermal reservoir consisting of natural heat which is stored in rocks or in aqueous liquid or vapor, whether or not under pressure.
- *Qualified Facility.* The electricity must be produced by a facility in the United States that is owned by the taxpayer seeking to claim the PTC and that is originally placed in service after October 22, 2004 and before the sunset date, discussed below. A facility generally is considered to be “placed in service” for this purpose when it is placed in a condition or state of readiness and availability to produce electricity.
- *Sold by the Taxpayer to an Unrelated Person.* The electricity must be sold by the taxpayer seeking to claim the PTC to an unrelated person during the year for which the PTC is sought.
- *No Advance Approval Required.* There is no advance approval requirement for claiming the PTC. A taxpayer who is entitled to the credit simply reports it on the taxpayer’s federal income tax return.

Calculation of the PTC

The PTC for any taxable year during the credit period generally is equal to 1.5 cents, adjusted for inflation, per kilowatt hour of electricity produced and sold during the taxable year. The adjusted PTC amount for electricity produced and sold during calendar year 2006 is 2.0 cents per kilowatt hour.

Credit Period

The PTC credit period for a qualifying geothermal facility is the 10-year period beginning on the date the facility was originally placed in service.

Sunset Date

To qualify for the PTC, electricity must be produced at a facility that is placed in service before January 1, 2009. The sunset dates have been extended a number of times since Section 45 was added to the Code, and a number of proposals have been made in Congress that would extend the sunset date beyond 2009. At present, however, it is unclear whether any of these proposals will be adopted.

Federal Energy Credit

Sections 46 and 48 of the Code provide a one-time credit against income tax for the cost of certain qualified geothermal energy property. The credit is calculated as a percentage, referred to as the “energy percentage,” of the tax basis (generally the cost) of any qualified “energy property” that is placed in service during a taxable year.

“Energy Percentage”

The “energy percentage” with respect to a geothermal facility is 10 percent.

“Energy Property”

The term “energy property” is defined for purposes of the energy credit to include any property that meets all of the following requirements:

- *Geothermal Equipment.* The property must be equipment that is used to produce, distribute, or use energy derived from a geothermal deposit. In the case of electricity generated by geothermal power, this includes only equipment that is used up to (but not including) the electrical transmission stage.
- *First Use or Construction by Taxpayer.* The property must be either (a) constructed, reconstructed, or erected by the taxpayer wishing to claim the credit or (b) if the property is acquired by purchase, the original use of the property must commence with that taxpayer wishing to claim the credit.
- *Depreciable or Amortizable.* The property must be eligible for depreciation or amortization for federal income tax purposes.
- *Performance and Quality Standards.* The property must meet performance and quality standards, if any, prescribed by the Secretary of the Treasury that are in effect at the time the property is placed in service. To date, the Secretary has not prescribed any such performance or quality standards.
- *Not Public Utility Property.* The property must not be “public utility property” as defined in Section 46(f)(5) of the Code, as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. This generally includes any property used predominantly in the business of selling steam through a local distribution system or transporting gas or steam by pipeline, if the rates for such sales or transportation are established or approved by a governmental unit or agency.

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.

Recapture of the Credit

The energy credit may be subject to recapture if a taxpayer sells or otherwise disposes of the energy property or stops using it in a manner that qualifies for the credit.

Federal Tax Credit Limitations

There are a number of limitations that apply to both the PTC and the energy credit. Following are a few examples of those limitations.

One Type of Credit Only (No Double Dipping)

A taxpayer cannot claim both the PTC and the energy credit with respect to a particular geothermal facility. If a taxpayer claims the one-time energy credit with respect to the cost of a facility, the taxpayer cannot also claim the PTC with respect to electricity produced by the facility. Likewise, if a taxpayer claims the PTC with respect to electricity produced from a facility, the taxpayer cannot also claim the energy credit with respect to the cost of the facility.

Cutback for Subsidized Energy Financing or Industrial Development Bonds

Both the PTC and the energy credit are limited with respect to facilities that are financed in whole or in part with certain government grants, proceeds of tax-exempt bonds, subsidized energy financing (that is, financing under a federal, state, or local program designed to provide subsidized financing for energy conservation projects), or other tax credits. All of the government funding available with respect to a particular facility should be carefully analyzed to determine whether and to what extent it will reduce the tax credits available with respect to the facility.

Alternative Minimum Tax Limitation

Both the PTC and the energy credit are part of the general business credit allowed pursuant to Section 38 of the Code. As a result, the benefit of the credit to a taxpayer may be limited by alternative minimum tax provisions (although a limited exception to this rule is made with respect to the PTC).

Nonrefundable; Carryover of Unused Credit

Both the PTC and the energy tax credit are “nonrefundable” credits. If a person entitled to claim a credit does not have sufficient income tax liability to use the entire credit for a particular year, that person generally will not be entitled to a refund of federal income tax on account of the credit. Any unused portion of the credit, however, generally may be carried back one tax year and forward 20 tax years.

Monetizing Credits

A taxpayer that has little or no need for tax credits (because, for example, it has little or no taxable income) may nevertheless be able to obtain some benefit from either the PTC or the energy credit by entering into an arrangement with an investor that does need tax credits. For example, a taxpayer could enter into a partnership with an investor that is willing to contribute cash to help fund construction of a geothermal facility. The partnership could then construct and operate the facility and, within certain limits, tax credits could be allocated to the partner having a need for credits. Another possible technique would be for an investor to own the facility and to enter into a power purchase agreement and an operation and maintenance agreement with the taxpayer. A taxpayer also may be able to lease a qualified facility to an investor and, with certain limitations, pass the credit to the lessee. Each of these techniques, and any other technique for monetizing tax credits, involves uncertainty

and requires careful tax planning. These and other considerations should be taken into account when choosing the type of entity that will own a geothermal facility and the various financing alternatives available.

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, geothermal deposits. 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. The potential deduction for intangible drilling and development costs also should be carefully analyzed in any transaction in which a developer wishes to monetize tax credits associated with the resulting geothermal facility.

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.

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 tax years starting after June 30, 2005. 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. Although the amount of the BETC may be reduced by federal subsidies, the 2007 legislation eliminated the former requirement that the BETC be reduced by the federal energy credit discussed above.

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

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.

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. In Washington, central or local assessment depends in part on whether the company’s property crosses county lines. Central assessment means that the amount of property tax is determined by the state revenue authority rather than by the county assessor’s office.
- *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.* Some states 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 and Washington, impose retroactive 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 a fixed cost. Nevada and Montana, for example, offer a property tax exemption for certain renewable energy facilities, including geothermal energy facilities. 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. The Strategic Investment Program statutes recently were revised to lower the minimum investment threshold. Negotiations for benefits under both the Enterprise Zone and Strategic Investment Programs generally occur at the county level, sometimes with participation of cities.

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 3.62 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 are allowed for revenues derived from the sale of electricity for resale, among other deductions. To the extent a business is subject to the state PUT, that business will not be subject to the Washington business and occupation tax. Cities and towns may impose a PUT of up to 6 percent of gross revenues derived from conducting an electrical energy business.
- *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.