

LAW OF BIOFUELS
—Tax Issues—

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

I. Excise Tax Credit

A. Excise Tax. Section 4081 of the Internal Revenue Code of 1986, as amended (the “Code”), imposes an excise tax on removal of a taxable fuel from a refinery or terminal, entry of a taxable fuel into the United States and sale of a taxable fuel not previously taxed upon removal or entry. “Taxable fuel” for this purpose includes gasoline, diesel fuel and kerosene. The rates of the excise tax currently are 24.3 cents per gallon of diesel fuel or kerosene and 18.3 cents per gallon for gasoline (except for aviation gasoline and kerosene, which have different rates).

B. Excise Tax Credit. Section 6426 of the Code creates a credit against the excise tax on taxable fuels. The excise tax credit generally is available to anyone that blends alcohol or biodiesel with taxable fuel in a mixture. To qualify for the credit, a qualifying mixture must either be sold by the producer to a buyer for use by the buyer as a fuel or must be used as a fuel in the trade or business of the producer. The amount of the excise tax credit is 60 cents per gallon of alcohol (51 cents per gallon for mixtures containing ethanol) and 50 cents per gallon of biodiesel (\$1.00 per gallon for agri-biodiesel) used by the taxpayer in producing the mixture.

C. Refundable Credit. The excise tax credit is fully refundable. To receive a refund, a blender must first apply the excise tax credit against any excise tax liability for a particular taxable year. To the extent the blender has any excise tax credit remaining after applying the credit against its excise tax liability, the blender may request a refund of the excess credit or may apply the excess credit against its income tax liability.

II. Income Tax Credit

A. Alcohol Fuels Credit. Section 40 of the Code creates a credit against income tax liability for alcohol used as a fuel (the “alcohol fuels credit”). The alcohol fuels credit for any person for any tax year is the sum of the “alcohol mixture credit,” the “alcohol credit” and the “small ethanol producer credit.”

1. Alcohol Mixture Credit. The alcohol mixture credit generally is 60 cents per gallon of alcohol used in production of a qualified mixture (51 cents per gallon of ethanol). A “qualified mixture” for this purpose is a mixture of alcohol and gasoline that is either sold in the course of the producer’s trade or business for use as a fuel by the buyer, or that is used as a fuel by the producer in the course of the producer’s trade or business. To qualify for the credit, the alcohol used in the mixture must be at least 150 proof. If alcohol is used with a proof of at least 150 but less than 190, the alcohol mixture credit is reduced to 45 cents per gallon (37.78 cents per gallon of ethanol).

2. Alcohol Credit. The alcohol credit is 60 cents per gallon of alcohol (51 cents for ethanol) used or sold by the taxpayer that is not in mixture. To qualify for this credit, the alcohol must be used by the producer as a fuel in the producer’s trade or business or sold by the producer at retail and placed in the fuel tank of the buyer’s vehicle. As with the alcohol mixture credit, the alcohol must be at least 150 proof. If alcohol is used with a proof of at least 150 but less than 190, the alcohol credit is reduced to 45 cents per gallon (37.78 cents per gallon of ethanol).

3. Small Ethanol Producer Credit. The small ethanol producer credit is 10 cents per gallon of qualified ethanol fuel production by an eligible small ethanol producer. An “eligible small ethanol producer” is any producer with capacity to produce not more than 60 million gallons of alcohol per year. The credit applies only to “qualified ethanol fuel production,” which is limited to 15 million gallons of ethanol per year per producer. To qualify for the credit, the ethanol must be either (a) sold by the producer to a buyer (i) for use by the buyer in the production of a qualified alcohol mixture in the buyer’s trade or business (other than casual off-farm production), (ii) for use as a fuel in the buyer’s trade or business, or (iii) for sale by the buyer to a third person and placed in the fuel tank of the third person; or (b) used or sold by the producer for any of these three purposes.

B. Biodiesel Fuels Credit. The biodiesel fuels credit provided in Section 40A of the Code is similar to the alcohol fuels credit. The credit is the sum of the “biodiesel mixture credit,” the “biodiesel credit” and the “small agri-biodiesel producer credit.”

1. Biodiesel Mixture Credit. The biodiesel mixture credit is available to a blender of biodiesel and diesel fuel that either is sold in a trade or business of the producer to any person for use as a fuel, or is used as a fuel in a trade or business of the producer. The amount of the credit is 50 cents per gallon of biodiesel used in a qualified mixture.

2. Biodiesel Credit. The biodiesel credit is available to any person that either uses biodiesel as a fuel in a trade or business or sells biodiesel at retail and places the biodiesel in the fuel tank of the buyer’s vehicle. The amount of the credit is 50 cents per gallon of qualifying biodiesel.

3. Small Agri-biodiesel Producer Credit. The small agri-biodiesel producer credit is available to any producer with agri-biodiesel production capacity of 60 million gallons per year or less. “Agri-biodiesel” is defined for this purpose as biodiesel derived solely from certain virgin oils and animal fats. To qualify for the credit, the producer must either (a) sell the agri-biodiesel to a buyer (i) for use by the buyer in the production of a qualified biodiesel mixture in the buyer’s trade or business, (ii) for use as a fuel in the buyer’s trade or business, or (iii) who sells the agri-biodiesel at retail to a third person and places the agri-biodiesel in the fuel tank of the third person, or (b) use the agri-biodiesel itself for one of these purposes. The amount of the credit is 10 cents per gallon of qualified agri-biodiesel.

III. General Federal Tax Credit Issues

A number of federal tax issues apply to both the excise tax credit and the income tax credits for alcohol and biodiesel.

A. No Doubling Up. The amount of the income tax credit for both alcohol fuels and biodiesel for any taxable year is reduced to take into account any benefit realized by the producer with respect to the same alcohol or biodiesel as a result of the excise tax credit. Thus, a producer cannot benefit from both the income tax credit and the excise tax credit with respect to the same alcohol or biodiesel.

B. Inclusion of Biofuels Credits in Income. A producer that claims the alcohol fuels credit or the biodiesel fuels credit must include the amount of the credit in gross income for federal income tax purposes.

C. Use as a Fuel. The IRS has ruled that “use as a fuel” in a trade or business of a taxpayer includes not only use as a motor vehicle fuel but also use for production of electricity and use as a heating fuel.

D. Carryforward and Carryback. If a producer qualifies for the income tax credits and is unable to use the entire amount of the credit in the year of production, any unused credits may be carried back one year or carried forward 20 years. Unlike the excise tax credit, unused income tax credits are nonrefundable.

E. Registration With IRS. Every person producing or blending biodiesel or alcohol as fuel is required to register with the IRS. The applicant must file IRS Form 637, Application for Registration (For Certain Excise Tax Activities), and receive a letter of registration from the IRS.

F. Aggregation Rules. Aggregation rules apply for purposes of the small ethanol producer credit and the small agri-biodiesel producer credit that may prevent a holding company from directly owning several facilities or indirectly owning facilities through subsidiaries. In addition, Sections 40(g)(2) and 40A(e)(2) of the Code treat all members of the same controlled group of corporations and all persons under common control (“more than 50%” ownership test) as one “person” for purposes of qualifying for both the 15 million gallon annual production and the 60 million gallon capacity limits.

G. Credit Recapture. To the extent that a producer does not use alcohol or biodiesel as a fuel in the producer’s trade or business or separates alcohol or biodiesel from a qualified mixture, the producer will be liable for a tax essentially equal to any credit previously claimed with respect to the alcohol, biodiesel, or alcohol or biodiesel mixture. Actions of the third person to whom fuel was sold also may have this effect.

H. Other Types of Biofuels. In addition to the principal federal credits for alcohol and biodiesel sold or used as fuel, other federal credits may be available for production of fuels from biomass. Examples include the income tax credit for renewable diesel produced from biomass and the production tax credit for production and sale of gas from biomass.

I. Sunset Dates. The excise tax credit does not apply to any sale, use or removal of alcohol fuel after December 31, 2010 or biodiesel after December 31, 2008. The alcohol fuels credit is not available for sale or use of alcohol fuels after December 31, 2010. The biodiesel fuels credit is not available for sale or use of biodiesel or agri-biodiesel after December 31, 2008. These sunset dates have been extended by Congress in the past and current legislation before the U.S. Senate would extend the sunset dates beyond 2008 and 2010. At present, however, it is unclear whether Congress will adopt any of these proposals.

IV. State and Local Tax Issues

In addition to federal income tax issues, construction and operation of biofuel facilities also raise numerous state and local tax issues.

A. Net Income Tax States. Forty-six states impose a corporate 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, each state’s tax system is different and must be separately analyzed.

1. Nexus and Apportionment. Siting a biofuel project in a state generally will create “nexus” with the state and will allow the state to tax the income of the company that owns or operates the project. Less substantial activities, such as consulting, also may create nexus with a state.

States generally measure the taxable income of a multistate business by allocation and apportionment. There is a trend toward apportioning income based solely on sales within the state. However, many states still apportion a company’s overall business income based on property and payroll, as well as sales, in the state. In determining where a sale of electricity occurs, some states such as California source the sale based on where the majority of the income-producing activity occurs. Other states may use different sourcing rules for sales of electricity.

One of the most important decisions affecting state taxation is the type of legal entity to use when starting a new project. Choices may include corporations (including S corporations and C corporations), limited liability companies (LLCs) and limited partnerships. In some states, the decision can determine whether a project’s state tax liability (or loss) is determined on a stand-alone basis, or whether state tax will be imposed on all of the income of the ultimate owners.

Typically, each project in a state is owned by a separate LLC. States generally treat these LLCs as “pass-through” or “disregarded” entities for state income tax purposes, just as under federal tax law. For example, a project LLC may be a nontaxable entity, and its ultimate owner or owners often are liable for state income tax. The amount of state tax owed by the owners depends on how the state apportionment rules are applied to the owners’ taxable income. The results are similar when the project is owned by a limited partnership.

Using a corporation as the project entity may or may not cause the project’s income to be taxed on a stand-alone basis, depending on the state. More than one-half of the states are “separate return” states: Tax is imposed only on the apportioned income of the particular corporation doing business in the state, even if the corporation is part of a consolidated group. Other states, particularly western states, impose a “unitary tax”: Tax is imposed on the combined income of some or all members of the corporate group, as apportioned to the state.

The apportionment rules can produce surprising results. For example, state tax may be owing even though for accounting purposes the project is generating losses on a stand-alone basis. This can happen when project companies are formed as LLCs or partnerships, or when project companies are corporations and the state imposes a unitary tax. In all of these cases, tax is effectively imposed on the income of the ultimate owners (on an apportioned basis), rather than simply on the income of the project itself. This can be an important consideration for modeling purposes.

2. Income Tax Incentives. Some income tax states offer incentives to promote the development of biofuels 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 PTC 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 an energy conservation project to claim a credit against Oregon income tax to offset the eligible costs of construction of the project. The Oregon Department of Energy has indicated informally that biofuel facilities may be eligible for the BETC if the biofuel blend is 20 percent or greater. The amount of the credit is 35 percent of the eligible costs, up to a maximum total credit amount of \$3.5 million.

The total credit amount is claimed over five years, and unused credit may be carried forward for up to eight years. Oregon law allows the BETC to be sold to another taxpayer, which is a benefit for companies that have insufficient Oregon taxable income to use the BETC. The IRS recently issued a ruling determining that the BETC does not reduce the amount of PTC that is available. It is possible, however, that Oregon law may reduce the amount of BETC if the PTC is claimed with respect to production from the facility.

B. Sales and Use Taxes. Forty-six 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.

1. Purchase or Use of Equipment. The purchase of machinery and equipment generally is subject to sales or use tax. However, some states, including California, Washington and Utah, have provided exemptions for sales of machinery or equipment to be used in manufacturing. In addition, some states have adopted specific exemptions for the purchase of alternative energy machinery or equipment. For example, Washington provides an exemption for the sale of machinery or equipment related to biodiesel fuels that contain at least 20 percent biodiesel by volume.

2. 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.

C. Property Tax. Virtually all states impose property tax that is measured by the value of real property and is assessed annually. Most states also tax tangible personal property that is used for business purposes. Intangible property generally is not taxed, except that some states tax intangible property of a company that generates or sells electricity.

1. 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. In some states, projects with a value in excess of a specific dollar threshold are valued by the state revenue authorities rather than the local county assessor.

2. Rollback Penalties in Farm and Timber Use Areas. Some states, such as Oregon, impose property tax penalties when land that had been used for farming or timber is dedicated to a different use. In addition to those penalties, the property is subject to a higher rate of tax after the change of use.

3. Property Tax Incentives. As part of due diligence in constructing or acquiring a biofuel facility, it is worthwhile to inquire whether any property tax incentives are available. In Oregon, for example, it may be possible to obtain a temporary property tax exemption under the state enterprise zone program. Enterprise zones are geographic areas established by one or more cities or counties within which new property may obtain an exemption, typically for three to five years. To qualify, state law requires that the company increase its permanent, full-time employment within the zone by at least 10 percent (i.e., 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.

Oregon legislation in 2003 facilitates biofuel projects by allowing any rural county to apply to become a Rural Renewable Energy Development Zone (RRED Zone). A county that becomes an RRED Zone may grant

exemption for renewable energy projects (which may include certain kinds of biofuel projects) throughout the county, without regard to the boundaries of the regular enterprise zone within the county. A per-county cap applies: The value of renewable energy property within the county that is eligible for the exemption may not exceed \$100 million. As an alternative to enterprise zone benefits, the Oregon Strategic Investment Program (SIP) allows a 15-year partial property tax exemption upon approval of the county and any city where the project is located. Under a 2003 law change, a project in a rural area may be eligible for the SIP exemption if the project has a cost of \$25 million or more; a project in an urban area must have a cost of \$100 million or more. The project value in excess of the applicable dollar threshold is exempt from property tax, although the owner is required to pay a community service fee, and local governments may negotiate for additional payments or consideration.

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

1. Gross Receipts Taxes. Some state and local governments may impose a tax on business gross receipts for the privilege of engaging in business in that state or locality. Gross receipts taxes typically are not reduced by any of the costs of doing business unless specifically provided for by the state or locality. For example, Washington currently allows a deduction from gross receipts in computing the Business and Occupation Tax for gross receipts attributable to the sale or distribution of biodiesel fuel (this provision is scheduled to expire on July 1, 2009).

2. State and Local Fuel Taxes. States generally impose an excise tax on motor vehicle fuel sold within the state. Some states provide certain tax incentives reducing excise taxes on sales of alternative fuels. For example, California provides that the excise tax rate for fuel containing at least 85 percent ethanol or methanol is 50 percent of the rate for other fuel. A few states, including California and Oregon, permit local governments within the state to assess a separate excise tax on fuel sales within the locality.

3. Other State and Local Excise Taxes. Other states and localities may impose other kinds of excise taxes. For example, some Nevada counties and 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. All potentially applicable taxes, including state and local excise taxes, should be carefully analyzed in determining the costs and benefits of operating a biofuel project.