

**THE LAW OF WIND**  
—Tax Issues—

**Adam C. Kobos**  
Stoel Rives LLP  
900 SW Fifth Avenue, Suite 2600  
Portland, OR 97204  
503-294-9246  
ackobos@stoel.com

**Robert T. Manicke**  
Stoel Rives LLP  
900 SW Fifth Avenue, Suite 2600  
Portland, OR 97204  
503-294-9664  
rtmanicke@stoel.com

**Kevin T. Pearson**  
Stoel Rives LLP  
900 SW Fifth Avenue, Suite 2600  
Portland, OR 97204  
503-294-9622  
ktpearson@stoel.com

The taxation system is often used to implement governmental policy directives. Because the wind power industry is developing at the crossroads of several important trends in public policy, wind power projects raise numerous federal, state, and local tax issues in addition to those involved in general choice-of-entity considerations. These tax issues create the potential for significant economic benefits if wind power project ownership is structured carefully. But if not carefully analyzed, tax matters can cause significant costs and competitive disadvantages.

**I. Federal Income Tax: 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 wind. This credit is known as the “production tax credit” (“PTC”).

**A. Requirements for Claiming the Credit.** The PTC for wind power applies only to electricity that is produced at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service and sold by the taxpayer to an unrelated person during the taxable year. Each of the following requirements must be satisfied for a taxpayer to claim the PTC:

1. **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. A partnership, however, should be treated as one person for purposes of this rule, so that the individual partners are not treated as owning individual allocable portions of a facility owned by the partnership.

2. **Qualified Energy Resources.** The electricity must be produced from wind or another listed renewable resource.

3. **Qualified Facility.** The electricity must be produced by a facility located in the United States that is owned by the taxpayer seeking to claim the PTC and, with respect to wind and most other renewable resources, that was originally placed in service after December 31, 1993 and before January 1, 2009. A facility generally is considered to be “placed in service” for purposes of this rule when the wind turbines are placed in a condition or state of readiness and are available to produce electricity. Each wind turbine that is capable of being separately operated and metered, together with its tower and supporting pad, is considered a separate “facility” for purposes of this placed-in-service rule.

4. **Sold by the Taxpayer.** The electricity must be sold by the taxpayer seeking to claim the PTC to an unrelated person during the taxable year for which the PTC is sought.

5. **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 taxpayer’s federal income tax return.

**B. Calculation of the Credit.** The PTC for any taxable year generally is equal to 1.5 cents multiplied by the number of qualified kilowatt hours of electricity produced and sold by the taxpayer during the taxable year. The 1.5 cents is multiplied by the inflation adjustment factor published by the IRS for the calendar year in which the sale of qualified electricity occurs. For electricity produced and sold during 2008, the inflation-adjusted PTC amount is 2.1 cents per kilowatt hours.

**C. Disqualified Wind-Generated Electricity.** Disqualified wind-generated electricity is not taken into account in computing the PTC. With certain exceptions, disqualified wind-generated electricity

generally is electricity that is (1) produced at a facility using wind that is placed in service by the taxpayer after June 30, 1999 and (2) sold to a utility under a contract originally entered into before January 1, 1987, whether or not amended or restated after that date.

**D. Nonrefundable Credit.** The PTC is a “nonrefundable” credit. If a person entitled to claim the PTC does not have sufficient income tax liability to use the entire PTC for a particular year, that person generally will not be entitled to a refund of federal income tax as a result of the PTC. Unused PTCs may, however, subject to certain conditions, be carried forward to subsequent taxable years and/or back to previous taxable years for which the person entitled to claim the credit has or had sufficient income tax liability to use the credit.

**E. Cutback for Other Grants and Credits.** The amount of the PTC is reduced with respect to certain grants, tax-exempt bond proceeds, and subsidized energy financing used to fund construction of a project, as well as with respect to certain other credits allowable with respect to property that is part of the project. There is relatively little authority regarding the circumstances under which the PTC is reduced to reflect other credits with respect to property that is part of the project. The IRS has, however, ruled that certain specific state tax credits do not reduce the PTC. In general, a cash award from a government body is more likely to reduce the PTC if the amount of the award is measured by the cost of construction, rather than by the amount of electricity generated. These issues should be carefully analyzed in financing a wind power facility.

**F. Sunset Date.** For wind power to qualify for the PTC, electricity must be produced at a facility that was originally placed in service before January 1, 2009. Earlier sunset dates were extended a number of times after section 45 was originally added to the Code (once retroactively after the PTC had expired for a number of months), and a number of attempts have been made to pass legislation that would extend the sunset date beyond January 1, 2009. Although none of these attempts has been successful to date, many practitioners and industry representatives continue to be hopeful that future legislation will reinstate the PTC for facilities placed in service in 2009 and beyond. Under present law, however, electricity produced by a wind facility that is placed in service on or after January 1, 2009 will not qualify for the PTC.

**G. Monetizing the Credit.** A taxpayer that has little or no need for tax credits (*e.g.*, because it has little or no taxable income) may nevertheless be able to obtain the benefit of the PTC by entering into an arrangement with an investor that needs credits. For example, a taxpayer could enter into a partnership with an investor that is willing to contribute cash to help finance a wind power facility. The partnership could then operate the facility and, within certain limits, the PTC could be allocated to the partner having a need for credits. In 2007 the IRS published guidance (Revenue Procedure 2007-65) that establishes a safe harbor for structuring these partnership transactions. There are a number of specific requirements that must be satisfied to qualify for the safe harbor. Thus this and other potential techniques for “monetizing” the PTC involve risk and require careful tax planning. These and other 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.

**II. State and Local Tax Issues.** In addition to federal income tax issues, construction and operation of wind power facilities also raise numerous state and local tax issues.

**A. Net Income Tax States.** More than 40 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 wind 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, may also 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 ("LLC"s), 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 wind 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 PTC available for the project.

For example, Oregon has adopted a business energy tax credit ("BETC"). The BETC program allows an Oregon taxpayer that owns and operates a wind power project to claim a credit against Oregon income tax to offset the eligible costs of construction of the project. The amount of the credit is 50 percent of the eligible costs, up to a maximum total credit amount of \$10 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 other taxpayers,

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, and the Oregon legislature amended the law in 2008 to clarify that claiming federal credits does not reduce the costs that may be counted toward the BETC.

**B. Sales and Use Taxes.** More than 40 states impose a sales tax. In most states, the tax is imposed only on sales of tangible personal property. Some states also impose sales or 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 Turbines and Other Equipment.** Sales and use taxes generally will apply to purchases or use of turbines and other equipment. An increasing number of states, however, have adopted an exemption from sales tax for machinery and equipment used in renewable electricity projects, including Washington, Idaho, and Colorado.

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 wholesale sales of electricity.

**C. Property Tax.** Almost 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 is taxable in some states if the owner is centrally assessed as discussed below.

1. **Central Assessment Likely.** In many western states, such as Oregon and Washington, a company that produces electricity is automatically “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.

2. **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. Industry efforts to obtain special valuation rules that take into account the unique aspects of wind power have been successful in some states, such as Colorado. It is often useful to consult an expert in the area of utility appraisal.

3. **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.

4. **Rollback Penalties in Farm and Timber Use Areas.** Some states, such as Oregon and Washington, impose property tax penalties when land that is 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. This issue typically arises when leases for turbine sites are negotiated.

5. **Property Tax Incentives.** As part of due diligence in constructing or acquiring a wind 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 law facilitates wind projects by allowing any county to designate its rural areas as a “Rural Renewable Energy Development” zone (“RRED Zone”). A RRED Zone may grant exemption for renewable energy projects (including wind power projects) throughout the rural area, 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 \$250 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 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 considerations.

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

1. **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, among other things, revenues derived from the sale of electricity for resale. 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.

2. **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 apportioned gross receipts for the privilege of doing business as an LLC. All potentially applicable taxes, including state and local excise taxes, should be carefully analyzed in determining the costs and benefits of operating a wind power project.