The tax system often is used to provide incentives for particular types of investments 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.


   A. The Investment Tax Credit. The owner of a qualified solar facility may claim the investment tax credit (the “ITC”). 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 solar facility that is placed in service before January 1, 2017 is 30% of the tax basis (generally the cost) of the qualifying property. The amount of the ITC for a solar facility that is placed in service on or after January 1, 2017 is 10% 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 solar facility to include only property that meets the following requirements:

         a. Solar Equipment. The property must be equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. In addition, equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight may qualify for the ITC, but only with respect to periods ending before January 1, 2017. Property used to generate energy for the purposes of heating a swimming pool does not qualify for the ITC.

         b. First Use or Construction by Taxpayer. If the property is acquired by purchase, the original use of the property must commence with the taxpayer claiming the credit. Otherwise, the property must be constructed, reconstructed, or erected by the taxpayer claiming the credit.

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

         d. Performance and Quality Standards. The property must meet any applicable performance and quality standards prescribed by the Secretary of the Treasury. To date, the Secretary has not prescribed any such standards.

         e. Public Utility Property. Under prior law, the property could 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. Under recent legislation, this restriction generally was removed for property placed in service after February 13, 2008 (and for self-constructed property, to the extent of the basis attributable to the period after February 13, 2008).

      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 ITC 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 solar facility with respect to which the 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.** Under prior law, the ITC for a solar project generally was reduced with respect to facilities that were financed in whole or in part with the proceeds of tax-exempt bonds, subsidized energy financing, or other forms of government-supported financing. Under recent legislation, this restriction generally was removed for property placed in service after December 31, 2008 (and for self-constructed property, to the extent of the basis attributable to the period after December 31, 2008).

6. **Nonrefundable Credit.** The ITC 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% ITC, a facility must be placed in service before January 1, 2017. There is no sunset date for the 10% ITC for solar facilities.

B. **U.S. Treasury Department Grants.** The American Recovery and Reinvestment Act of 2009 allows the owner of a qualified solar facility that is eligible for the ITC to elect to receive a grant from the U.S. Treasury Department in lieu of claiming the ITC 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 qualified project otherwise would have been eligible.

1. **Qualification for Grant.** To qualify for a grant, a solar project must (i) meet the qualification requirements 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, 2017.

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

3. **Excluded from Income.** A grant generally is not included in the taxable income of the recipient. An exception exists for certain lease transactions.

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 Allowed.** No ITC 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.

C. **Bonus Depreciation and MACRS Depreciation.** In addition to tax credits or grant payments, solar 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 percent of the adjusted basis of the property in 2009. The remaining 50 percent of the adjusted basis of the property is depreciated over the regular tax depreciation schedule.

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

D. **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 solar 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. 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 solar 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 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.

II. **State and Local Tax Issues.** In addition to federal income tax issues, construction and operation of solar 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.

1. **Nexus, Business Structure, and Apportionment.** Siting a solar 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.

One of the most important decisions affecting state taxation is the type of legal entity used when starting a new project. Choices may include corporations (including S corporations and C corporations), limited liability companies (“LLCs”), and limited partnerships. The decision can affect:

- Whether tax is imposed directly on the project company or on its owners; and
- Whether taxable income (or loss) is determined on a stand-alone basis or whether state tax will be measured by combining or consolidating the income of affiliates, including the parent company.

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. However, 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 choice-of-entity and apportionment rules can sometimes produce surprising results: if the company or group 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.

2. **Income Tax Incentives.** Some income tax states offer incentives to promote the development of solar energy and other alternative energy projects. It is important to understand the nature of each incentive, as there is considerable variation among the states.

   a. **Oregon BETC.** For example, Oregon has adopted a business energy tax credit (the “BETC”). The BETC program allows an Oregon taxpayer that owns and operates a solar energy 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 2007 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 credits may be carried forward for up to eight years. A developer may sell the BETC outright, at a discount established by the state and recalculated quarterly. Certain other incentives, including federal grants, and potentially including the federal grant in lieu of 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.

   b. **Other States.** Hawaii and Montana are examples of other states that offer somewhat similar income tax credits for certain alternative energy systems, including solar 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.

1. **Purchase or Use of Equipment.** Most states’ sales and use taxes will apply to the purchase or use of equipment within those states.

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.

3. **Sales Tax Incentives.** Some states, such as Nevada, offer exemptions or other sales and use tax incentives for solar 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 solar energy. In 2009 Washington revised its sales and use tax incentive for certain alternative energy generation equipment, including machinery and equipment used in generating electricity from solar energy. 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.

1. **“Central” or “State” 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 taxable value of the property 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.

2. **Valuation.** States generally accept the three traditional valuation methods for valuing electricity generation property (the cost approach, income approach, and comparable sales approach). However, if the property is centrally assessed, the state taxing authority may also be authorized to determine value by combining the property with other facilities owned or used by the same company. In that case, the taxing authority may aggregate property within and without the state, determine the value of the entire “unit,” and allocate some portion of the unit value to the taxing state by means of a formula. Determining the correct value of a particular project is a matter of frequent controversy.

3. **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.

4. **Rollback Penalties in Farm and Timber Use Areas.** Many states 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 may increase prospectively after the change of use. It is best to address this issue as part of financial modeling.
5. Property Tax Incentives. As part of due diligence in constructing or acquiring a solar facility, it is worthwhile to inquire whether any property tax incentives are available. Property tax incentives can be particularly advantageous because property tax liability typically applies throughout the life of the project. In contrast to income tax, property tax is often highest in the early years before the project is profitable. Nevada and Montana, for example, offer a property tax exemption for certain renewable energy facilities, including solar energy facilities. California offers a property tax exemption for certain newly constructed solar energy facilities. The California exemption does not apply to facilities owned by centrally assessed companies or for which there has been a change in ownership for property tax purposes. 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 solar facility, state and local excise taxes also should 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 3.873 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.

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, 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 an LLC.