

**DESCRIPTION OF THE
“ENERGY POLICY TAX INCENTIVES ACT OF 2005”**

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 16, 2005, of the “Energy Policy Tax Incentives Act of 2005.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of provisions of the “Energy Policy Tax Incentives Act of 2005.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the “Energy Policy Tax Incentives Act of 2005,”* (JCX-44-05) June 14, 2005.

A. Electricity Infrastructure

1. Extension and modification of renewable electricity production tax credit

Present Law

In general

An income tax credit is allowed for the production of electricity from qualified facilities sold by the taxpayer to an unrelated person (sec. 45). Qualified facilities comprise wind energy facilities, closed-loop biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. In addition, an income tax credit is allowed for the production of refined coal.

Credit amounts and credit period

In general

The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2005. A taxpayer may claim credit for the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of the refined coal production credit) exceeds certain threshold levels.

Reduced credit amounts and credit periods

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the 10-year credit period is reduced to five years commencing on the date the facility is placed in service. In general, for eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992.

Credit applicable to refined coal

The amount of the credit for refined coal is \$4.375 per ton (also indexed for inflation after 1992 and equaling \$5.481 per ton for 2005).

Other limitations on credit claimants and credit amounts

In general, in order to claim the credit, a taxpayer must own the qualified facility and sell the electricity produced by the facility (or refined coal in the case of the refined coal production credit) to an unrelated party. Also, in general, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits. The reduction cannot exceed 50 percent of the otherwise allowable credit.²

The credit for electricity produced from renewable sources is a component of the general business credit (sec. 38(b)(8)). Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds \$25,000. Excess credits may be carried back one year and forward up to 20 years.

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

² In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

Summary of credit rate and credit period by facility type

**Table 1.–Summary of Section 45 Credit for Electricity Produced
from Certain Renewable Resources and Refined Coal**

Electricity produced from renewable resources	Credit amount for 2005 (cents per kilowatt- hour; dollars per ton)	Credit period (years from placed-in-service date) ¹
Wind.....	1.9	10
Closed-loop biomass.....	1.9	10
Open-loop biomass (including agricultural livestock waste nutrient facilities)	0.9	5
Geothermal.....	1.9	5
Solar.....	1.9	5
Small irrigation power.....	0.9	5
Municipal solid waste..... (including landfill gas facilities and trash combustion facilities)	0.9	5
Refined Coal	5.481	10

¹ For eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

Periods for which credit allowable

In order to be a qualified facility–

Wind energy facility

A wind energy facility must be placed in service after December 31, 1993, and before January 1, 2006.

Closed-loop biomass facility

A closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2006. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2006.

Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility must be placed in service after October 22, 2004 and before January 1, 2006, in the case of a facility using agricultural livestock waste nutrients and

must be placed in service at any time prior to January 1, 2006 in the case of a facility using other open-loop biomass.

Geothermal, solar, small irrigation, landfill gas, and trash combustion facilities

To be a qualifying facility, a geothermal, solar, small irrigation, landfill gas, or trash combustion facility must be placed in service after October 22, 2004 and before January 1, 2006.

Refined coal facility

A refined coal facility must be placed in service after October 22, 2004 and before January 1, 2009.

Description of Proposal

The proposal extends the placed-in-service date by three years (through December 31, 2008) for the following qualifying facilities: wind facilities; closed-loop biomass facilities (including a facility co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass); open-loop biomass facilities; geothermal facilities; small irrigation power facilities; landfill gas facilities; and trash combustion facilities. The proposal does not extend the placed-in-service date for solar facilities (December 31, 2005) or refined coal facilities (December 31, 2008).

The proposal adds one new qualifying energy resource, fuel cells. A qualifying fuel cell facility is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that convert a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and generates at least 0.5 megawatts of electricity, and which is placed in service after December 31, 2005, and before January 1, 2009. The taxpayer can claim the 1.5 cents-per-kilowatt-hour (indexed for inflation) credit for a five-year period commencing on the date the facility is placed in service.

Effective Date

The proposal is effective on the date of enactment.

2. Clean renewable energy bonds

Present law

Tax-exempt bonds

Interest on State and local government bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of electric power facilities (i.e., generation, transmission, distribution, and retailing).

Interest on State or local bonds to finance activities of private persons (“private activity bonds”) is taxable unless a specific exception is contained in the Code (or in a non-Code provision of a revenue Act). The term “private person” generally includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2005, the State volume cap is the greater of \$80 per resident or \$239 million. The Code imposes several additional restrictions on tax-exempt private activity bonds that do not apply to bonds for governmental activities.

The tax exemption for State and local bonds does not apply to any arbitrage bond.³ A bond is defined as an arbitrage bond if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.⁴ In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

An issuer of State or local bonds must file with the IRS certain information about the bonds in order for such bonds to be tax-exempt.⁵ Generally, this information return is required to be filed no later than the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue “qualified zone academy bonds.”⁶ “Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds. A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located

³ Secs. 103(a) and (b)(2).

⁴ Sec. 148.

⁵ Sec. 149(e).

⁶ Sec. 1397E.

in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

There is an annual limitation of \$400 million on the amount of qualified zone academy bonds that may be issued in calendar years 1998 through 2005. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Tax credits for production of electricity from renewable sources

An income tax credit is allowed for the production of electricity from qualified facilities sold by the taxpayer to an unrelated person.⁷ The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2005. A taxpayer may claim credit for the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of the refined coal production credit) exceeds certain threshold levels.

Qualified facilities comprise wind energy facilities, closed-loop biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. In addition, an income tax credit is allowed for the production of refined coal.

To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2006. A closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2006. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2006. An open-loop biomass facility must be

⁷ Sec. 45.

placed in service after October 22, 2004 and before January 1, 2006, in the case of facility using agricultural livestock waste nutrients, and must be placed in service at any time prior to January 1, 2006 in the case of a facility using other open-loop biomass. Geothermal, solar, small irrigation, landfill gas, and trash combustion facilities all must be placed in service after October 22, 2004 and before January 1, 2006. In addition, a qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004 and before January 1, 2009.

Description of Proposal

The proposal creates a new category of tax credit bonds, “Clean Renewable Energy Bonds.” Clean Renewable Energy Bonds are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for facilities that qualify for the tax credit under section 45 (“qualified projects”), without regard to the placed in service date requirements of that section.

Like qualified zone academy bonds, Clean Renewable Energy Bonds are not interest-bearing obligations. Rather, the taxpayer holding a Clean Renewable Energy Bond on a credit allowance date would be entitled to a tax credit. The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of Clean Renewable Energy Bonds without discount and interest cost to the qualified issuer. The credit is includable in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

The proposal also imposes a maximum maturity limitation on any Clean Renewable Energy Bond. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a Clean Renewable Energy Bond being equal to 50 percent of the face amount of such bond.

For purposes of the proposal, “qualified issuers” include governmental bodies; the Tennessee Valley Authority; mutual or cooperative electric companies (either described in section 501(c)(12) or section 1381(a)(2)(C)), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and clean energy bond lenders. A clean energy bond lender means a cooperative lending organization which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and was in existence on February 1, 2002. The term “qualified borrower” includes a governmental body (including an Indian tribal government), the Tennessee Valley Authority, and a mutual or cooperative electric company.

Under the proposal, Clean Renewable Energy Bonds are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. In addition, to qualify as Clean Renewable Energy Bonds, 95 percent or more of the proceeds of such bonds must be spent on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as Clean Renewable Energy Bonds if

unspent proceeds are used within 90 days from the end of such five-year period to redeem an amount of outstanding bonds to satisfy the 95 percent expenditure test. The five-year spending period also may be extended by the Secretary upon the qualified issuer's request.

Unlike qualified zone academy bonds, the proposal requires issuers of Clean Renewable Energy Bonds to report issuance to the IRS in a manner similar to the information returns required for traditional tax-exempt bonds. Under the proposal, there is a national limitation of \$1 billion of Clean Renewable Energy Bonds that the Secretary may allocate, in the aggregate, to qualified projects. The authority to issue Clean Renewable Energy Bonds expires December 31, 2008.

Effective Date

The proposal is effective for bonds issued after December 31, 2005.

3. Treatment of income of certain electric cooperatives

Present Law

In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).⁸

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the

⁸ Announcement 96-24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996-16 I.R.B. 35.

cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code⁹ are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.¹⁰ The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.¹¹

Taxation of electric cooperatives exempt from subchapter T

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas."¹² Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.¹³

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative

⁹ Sec. 1381, et seq.

¹⁰ Sec. 1382.

¹¹ Sec. 521.

¹² Sec. 1381(a)(2)(C).

¹³ See Rev. Rul. 83-135, 1983-2 C.B. 149.

principles described above in order to qualify for tax exemption under section 501(c)(12).¹⁴ The 85-percent test is determined without taking into account any income from: (1) qualified pole rentals; (2) open access electric energy transmission services; (3) open access electric energy distribution services; (4) any nuclear decommissioning transaction; (5) any asset exchange or conversion transaction.¹⁵

Income from open access transactions

Income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by Federal Energy Regulations Commission (“FERC”) or under an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control—but not ownership—of transmission facilities) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

In addition, income is excluded for purposes of the 85-percent test if it is received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy distribution services or ancillary services, provided such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the cooperative: (1) to end-users who are served by distribution facilities not owned by the cooperative or any of its members; or (2) generated by a generation facility that is not owned or leased by the cooperative or any of its members and that is directly connected to distribution facilities owned by the cooperative or any of its members.

The exclusion for income from open access transactions does not apply to taxable years beginning after December 31, 2006.

Income from nuclear decommissioning transactions

Income received or accrued by a rural electric cooperative from any “nuclear decommissioning transaction” also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term “nuclear decommissioning transaction” is defined as—

1. any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative’s interest in a nuclear powerplant or nuclear powerplant unit;

¹⁴ Rev. Rul. 72-36, 1972-1 C.B. 151.

¹⁵ Sec. 501(c)(12)(C).

2. any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or
3. any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

The exclusion for income from nuclear decommissioning transactions does not apply to taxable years beginning after December 31, 2006.

Income from asset exchange or conversion transactions

Gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or natural gas.

The exclusion for income from asset exchange or conversion transactions does not apply to taxable years beginning after December 31, 2006.

Treatment of income from load loss transactions

Tax-exempt rural electric cooperatives

Under present law, income received or accrued by a tax-exempt rural electric cooperative from a “load loss transaction” is treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members.¹⁶ Therefore, income from load loss transactions is treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). In addition, income from load loss transactions does not cause a tax-exempt electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term “load loss transaction” is generally defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a seven-year period beginning with the “start-up year” does not exceed the reduction in the amount of sales of electric energy during such period by the cooperative to members. The “start-up year” is defined as the first year that the cooperative offers nondiscriminatory open access or, if later and at the election of the cooperative, 2004.

¹⁶ Sec. 501(c)(12)(H).

Present law also excludes income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

The special rule for income received or accrued by a tax-exempt rural electric cooperative from a load loss transaction does not apply to taxable years beginning after December 31, 2006.

Taxable electric cooperatives

The receipt or accrual of income from load loss transactions by taxable electric cooperatives is treated as income from patrons who are members of the cooperative.¹⁷ Thus, income from a load loss transaction is excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative. In addition, income from load loss transactions does not cause a taxable electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The special rule for income received or accrued by a taxable electric cooperative from a load loss transaction does not apply to taxable years beginning after December 31, 2006.

Description of Proposal

The proposal eliminates the sunset date for the rules excluding income received or accrued by tax-exempt rural electric cooperatives from open access electric energy transmission or distribution services, any nuclear decommissioning transaction, and any asset exchange or conversion transaction for purposes of the 85-percent test under section 501(c)(12). The proposal also eliminates the sunset date for the rule that allows income from load loss transactions to be treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test. In addition, the proposal eliminates the sunset date for the rule that permits taxable electric cooperatives to treat the receipt or accrual of income from load loss transactions as income from patrons who are members of the cooperative.

Effective Date

The proposal is effective on the date of enactment.

4. Dispositions of transmission property to implement FERC restructuring policy

Present Law

Generally, a taxpayer selling property recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain

¹⁷ Sec. 501(c)(12)(H).

is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period¹⁸ (the “reinvestment property”). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider¹⁹ approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

Description of Proposal

The proposal extends the deferral provision to sales or dispositions to an independent transmission company prior to January 1, 2008.

¹⁸ The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

¹⁹ For example, a regional transmission organization, an independent system operator, or an independent transmission company.

Effective Date

The proposal is effective for transactions occurring after the date of enactment. However, because the proposal is an extension of a present law provision which expires on December 31, 2006, only transactions occurring after December 31, 2006 and prior to January 1, 2008 will be affected.

5. Credit for production of electricity from advanced nuclear power facilities

Present Law

An income tax credit is allowed for production of electricity from qualified facilities sold by the taxpayer to an unrelated person (sec. 45). Qualified facilities comprise wind energy facilities, closed-loop biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2005. However, electricity produced at open-loop biomass, small irrigation power, and municipal solid waste facilities receives only 50 percent of the credit, or 0.9 cents per kilowatt-hour for 2005. Generally, wind and closed-loop biomass facilities may claim this credit for 10 years from the placed-in-service date of the facility. Other qualified facilities may claim the credit for only five years from the placed-in-service date.

Present law does not provide a credit for electricity produced at advanced nuclear power facilities.

Description of Proposal

The proposal permits a taxpayer producing electricity at a qualifying advanced nuclear power facility to claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight-year period starting when the facility is placed in service.²⁰ The aggregate amount of credit that a taxpayer may claim in any year during the eight-year period is subject to limitation based on allocated capacity and an annual limitation as described below.

A qualifying advanced nuclear facility is an advanced nuclear facility for which the taxpayer has received an allocation of megawatt capacity from the Secretary of Treasury, in consultation with the Secretary of Energy, and is placed in service before January 1, 2021. The taxpayer may only claim credit for production of electricity equal to the ratio of the allocated capacity that the taxpayer receives from the Secretary of Treasury to the rated nameplate capacity of the taxpayer's facility. For example, if the taxpayer receives an allocation of 750 megawatts of capacity from the Secretary and the taxpayer's facility has a rated nameplate

²⁰ The 1.8-cents credit amount is reduced, but not below zero, if the annual average contract price per kilowatt-hour of electricity generated from advanced nuclear power facilities in the preceding year exceeds eight cents per kilowatt-hour. The eight-cent price comparison level is indexed for inflation after 1992.

capacity of 1,000 megawatts, then the taxpayer may claim three-quarters of the otherwise allowable credit, or 1.35 cents per kilowatt-hour, for each kilowatt-hour of electricity produced at the facility (subject to the annual limitation described below). The Secretary of Treasury may allocate up to 6,000 megawatts of capacity.

A taxpayer operating a qualified facility may claim no more than \$125 million in tax credits per 1,000 megawatts of allocated capacity in any one year of the eight-year credit period. If the taxpayer operates a 1,350 megawatt rated nameplate capacity system and has received an allocation from the Secretary for 1,350 megawatts of capacity eligible for the credit, the taxpayer's annual limitation on credits that may be claimed is equal to 1.35 times \$125 million, or \$168.75 million. If the taxpayer operates a facility with a nameplate rated capacity of 1,350 megawatts, but has received an allocation from the Secretary for 750 megawatts of credit eligible capacity, then the two limitations apply such that the taxpayer may claim a credit equal to 1.35 cents per kilowatt-hour of electricity produced (as described above) subject to an annual credit limitation of \$93.75 million in credits (three-quarters of \$125 million).

An advanced nuclear facility is any nuclear facility for the production of electricity, the reactor design for which was approved after 1993 by the Nuclear Regulatory Commission. For this purpose, a qualifying advanced nuclear facility does not include any facility for which a substantially similar design for a facility of comparable capacity was approved before 1994.

In addition, the credit allowable to the taxpayer is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but such reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is treated as part of the general business credit and, under a special transition rule may not be carried back to a taxable year ending before or on the effective date of the provision.

Effective Date

The proposal applies to electricity produced in taxable years beginning after the date of enactment.

6. Credit for investment in clean coal facilities

Present Law

Present law does not provide an investment credit for electricity production facilities property that uses coal as a fuel or for the gasification of coal or other materials. However, a nonrefundable, 10-percent investment tax credit ("energy credit") is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). The energy credit is a component of the general business credit (sec. 38(b)(1)).

Description of Proposal

The proposal adds two new 20-percent investment tax credits to the energy credit. Both credits are available only to projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process.

With respect to the first investment tax credit, the proposal establishes a 10-year program to produce 6,500 megawatts of power generation capacity using integrated gasification combined cycle and other advanced coal-based electricity generation technologies. Qualified projects must be economically feasible and use the appropriate clean coal technologies. In determining which qualified projects to certify, the Secretary of Treasury shall give priority to projects that include carbon capture capability, increased by-product utilization and other benefits. The Secretary of Treasury, in consultation with the Secretary of Energy, must allocate up to 3,575 megawatts of power generation capacity to credit-eligible projects using an integrated gasification combined cycle technology. The remaining 2,925 megawatts of power generation capacity must be allocated to credit-eligible projects that use other advanced coal-based technologies.

With respect to the second investment tax credit, the proposal authorizes the certification of certain gasification projects. Qualified gasification projects convert coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. Under the proposal, certified gasification projects are eligible for the new 20 percent investment tax credit. The total value of credit-eligible expenditures on all certified gasification projects may not exceed \$4 billion. In addition, no single project may claim a gasification investment tax credit in excess of \$200 million.

Effective Date

The proposal applies to projects certified after the date of enactment.

7. Clean energy bonds for certified coal property

Present law

Tax-exempt bonds

Interest on State and local government bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of electric power facilities (i.e., generation, transmission, distribution, and retailing).

Interest on State or local bonds to finance activities of private persons (“private activity bonds”) is taxable unless a specific exception is contained in the Code (or in a non-Code provision of a revenue Act). The term “private person” generally includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these

tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2005, the State volume cap is the greater of \$80 per resident or \$239 million. The Code imposes several additional restrictions on tax-exempt private activity bonds that do not apply to bonds for governmental activities.

The tax exemption for State and local bonds does not apply to any arbitrage bond.²¹ A bond is defined as an arbitrage bond if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.²² In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

An issuer of State or local bonds must file with the IRS certain information about the bonds in order for such bonds to be tax-exempt.²³ Generally, this information return is required to be filed no later than the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue “qualified zone academy bonds.”²⁴ “Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds. A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

²¹ Secs. 103(a) and (b)(2).

²² Sec. 148.

²³ Sec. 149(e).

²⁴ Sec. 1397E.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

There is an annual limitation of \$400 million on the amount of qualified zone academy bonds that may be issued in calendar years 1998 through 2005. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Description of Proposal

The proposal creates a new category of tax credit bonds, “Clean Energy Coal Bonds.” Clean Energy Coal Bonds are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for “certified coal property.” Certified coal property is defined as any property that is part of a qualifying advanced coal project certified by the Secretary of Energy.

Like qualified zone academy bonds, Clean Energy Coal Bonds are not interest-bearing obligations. Rather, the taxpayer holding a Clean Energy Coal Bond on a credit allowance date would be entitled to a tax credit. The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of Clean Energy Coal Bonds without discount and interest cost to the qualified issuer. The credit is includable in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

For purposes of the proposal, “qualified issuers” include governmental bodies; the Tennessee Valley Authority; mutual or cooperative electric companies (either described in section 501(c)(12) or section 1381(a)(2)(C)), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and clean energy bond lenders. A clean energy bond lender means a cooperative lending organization which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and was in existence on February 1, 2002. The term “qualified borrower” includes a governmental body (including an Indian tribal government), the Tennessee Valley Authority, and a mutual or cooperative electric company.

Under the proposal, Clean Energy Coal Bonds are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. In addition, to qualify as Clean Energy Coal Bonds, 95 percent or more of the proceeds of such bonds must be spent on certified coal property within the five-year period that begins on the date of issuance. To the extent less than

95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as Clean Energy Coal Bonds if unspent proceeds are used within 90 days from the end of such five-year period to redeem an amount of outstanding bonds to satisfy the 95 percent expenditure test. The five-year spending period also may be extended by the Secretary upon the qualified issuer's request.

The proposal also imposes a maximum maturity limitation on any Clean Energy Coal Bond. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a Clean Energy Coal Bond being equal to 50 percent of the face amount of such bond.

Unlike qualified zone academy bonds, the proposal requires issuers of Clean Energy Coal Bonds to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. Under the proposal, there is a national limitation of \$1 billion of Clean Energy Coal Bonds that the Secretary may allocate, in the aggregate, to certified coal property projects. The authority to issue Clean Energy Coal Bonds expires December 31, 2010.

Effective Date

The proposal is effective for bonds issued after December 31, 2005.

B. Domestic Fossil Fuel Security

1. Credit for investment in clean coke/cogeneration manufacturing facilities

Present Law

Present law does not provide a credit for investment in clean coke/cogeneration manufacturing facilities property.

Description of Proposal

The proposal provides a 20-percent investment tax credit for qualified investments in clean coke/cogeneration facilities property. The proposal defines clean coke/cogeneration manufacturing facilities property as depreciable real and tangible personal property located in the United States that meets certain emission limitations and is used for the manufacture of metallurgical coke or for the production of steam or electricity from waste heat generated during the production of metallurgical coke.

The qualified investment for any taxable year is the basis of each coke/cogeneration facilities property placed in service by the taxpayer during such taxable year. The proposal excludes the credit from the basis adjustment rules for investment credit property set out in section 50(c) of the Code. Under the basis adjustment rules, the basis in investment credit property is generally reduced by the amount of the investment credit.

Effective Date

The proposal applies to property placed in service after the date of enactment and before December 31, 2009.

2. Temporary expensing for equipment used in the refining of liquid fuels

Present Law

Depreciation of refinery assets

Under present law, depreciation allowances for property used in a trade or business generally are determined under the Modified Accelerated Cost Recovery System (“MACRS”) of section 168 of the Internal Revenue Code. Under MACRS, petroleum refining assets are depreciated for regular tax purposes over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and its other components. Present law also provides a special expensing rule for small refiners for capital costs incurred in complying with Environmental Protection Agency sulfur regulations.

Taxation of cooperatives and their patrons

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception—the cooperative may exclude from its taxable

income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code²⁵ are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.²⁶ The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.²⁷

Description of Proposal

The proposal provides a temporary election to expense qualified refinery property. Qualified refinery property includes assets used in the refining of liquid fuels: (1) with respect to the construction of which there is a binding construction contract before January 1, 2008; (2) which is placed in service before January 1, 2012; (3) which increases the capacity of an existing refinery by at least five percent or increases throughput of qualified fuels (as defined in section 29(c)) by at least 25 percent; and (4) which meets all applicable environmental laws in effect when the property is placed in service.

The proposal also allows cooperatives to pass through to patrons the deduction permitted for qualified refinery property. To the extent the deduction for qualified refinery property is passed through to patrons, the cooperative is denied the deduction for such property or any depreciation deductions under sections 167 or 168 with respect to such property.

Effective Date

The proposal is effective for property placed in service after the date of enactment, the original use of which begins with the taxpayer, provided the property is not subject to a binding contract for construction as of June 14, 2005.

²⁵ Sec. 1381, et seq.

²⁶ Sec. 1382.

²⁷ Sec. 521.

3. Pass through to patrons the deduction for capital costs incurred by cooperative for complying with environmental protection agency sulfur regulations for small refiners

Present Law

Expensing and credit for small refiners

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. In addition, the Code permits small business refiners to immediately deduct as an expense up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency (“EPA”). Costs qualifying for the deduction are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009.

The Code also provides that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements. The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. As with the deduction permitted under present law, costs qualifying for the credit are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. The taxpayer’s basis in property with respect to which the credit applies is reduced by the amount of production credit claimed.

For these purposes a small business refiner is a taxpayer who is within the business of refining petroleum products, employs not more than 1,500 employees directly in refining, and has less than 205,000 barrels per day (average) of total refinery capacity. The deduction is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization. Present law does not permit cooperatives to pass through to members the deduction permitted for the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements.

Taxation of cooperatives and their patrons

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception—the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code²⁸ are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.²⁹ The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.³⁰

Description of Proposal

The proposal allows cooperatives to pass through to patrons the deduction permitted under section 179B for costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements. To the extent the deduction is passed through to patrons, the cooperative is denied the deduction it would otherwise be entitled under section 179B or for depreciation deductions under sections 167 or 168 with respect to costs attributable to calculation of the patrons' allowable section 179B deduction.

Effective Date

The proposal is effective for costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003, and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009.

4. Enhanced oil recovery credit for carbon dioxide injections

Present Law

Taxpayers may claim a credit equal to 15 percent of enhanced oil recovery ("EOR") costs. Qualified EOR costs include the following costs associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. The EOR credit is phased out when oil prices exceed a threshold amount.

²⁸ Sec. 1381, et seq.

²⁹ Sec. 1382.

³⁰ Sec. 521.

Description of Proposal

The proposal modifies the EOR credit to increase the credit rate to 20 percent with respect to any new EOR project or substantial expansion of an existing EOR project that occurs after the effective date and that uses carbon dioxide flooding or injection as an oil recovery method. The increased credit is available only for qualified EOR projects that use carbon dioxide that is (1) from a man-made, industrial source or (2) separated from natural gas and natural gas liquids at a natural gas processing plant.

Effective Date

The proposal applies to property placed in service after December 31, 2005, and before January 1, 2010.

5. Natural gas distribution lines treated as fifteen-year property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the class life of the property. The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.³¹ Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a statutory class life of 35 years for natural gas distribution lines placed in service before January 1, 2008.

Effective Date

The proposal is effective for property placed in service after the date of enactment, the original use of which commences with the taxpayer and which is not subject to a binding contract for acquisition by the taxpayer as of June 14, 2005.

³¹ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

C. Conservation and Energy Efficiency Provisions

1. Energy efficient commercial building deduction

Present Law

No special deduction is currently provided for expenses incurred for energy-efficient commercial building property.

Description of Proposal

In general

The proposal provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property: (1) which is installed on or in any building located in the United States, (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (“ASHRAE/IESNA”). The deduction is limited to an amount equal to \$2.25 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Eligible buildings may include any residential rental property, including any low-rise multifamily structure or single family housing property which is not within the scope of Standard 90.1-2001.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual. The methods for calculation shall be fuel neutral, such that the same energy efficiency features shall qualify a building for the deduction under this subsection regardless of whether the heating source is a gas or oil furnace or boiler or an electric heat pump. The calculation methods shall provide appropriate calculated energy savings for design methods and technologies not otherwise credited in either Standard 90.1-2001 or in the 2005 California Nonresidential Alternative Calculation Method Approval Manual, including the following: (i) Natural ventilation, (ii) Evaporative cooling, (iii) Automatic lighting controls such as occupancy sensors, photocells, and timeclocks, (iv) Daylighting, (v) Designs utilizing semi-conditioned spaces which maintain adequate comfort conditions without air conditioning or without heating, (vi) Improved fan system efficiency, including reductions in static pressure, (vii) Advanced unloading mechanisms for mechanical cooling, such as multiple

or variable speed compressors, (viii) The calculation methods may take into account the extent of commissioning in the building, and allow the taxpayer to take into account measured performance which exceeds typical performance, (ix) On-site generation of electricity, including combined heat and power systems, fuel cells, and renewable energy generation such as solar energy, and (x) Wiring with lower energy losses than wiring satisfying Standard 90.1-2001 requirements for building power distribution systems.

The Secretary shall prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

Partial allowance of deduction

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is \$0.75 per square foot for each separate system.

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets. However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 37.5 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions.

Effective Date

The proposal is effective for property placed in service after the date of enactment and prior to January 1, 2010.

2. Energy efficient new homes

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the construction of new energy-efficient homes.

Description of Proposal

The proposal provides a credit to an eligible contractor of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction. The credit cannot exceed \$1,000 (\$2,000) in the case of a new home that has a projected level of annual heating and cooling costs that is 30 percent (50 percent) less than a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on the date of enactment, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, 1/3 of such 30 percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, 1/5 of such 50 percent savings must come from the building envelope.

The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property is any energy-efficient building envelope component (insulation materials or system specifically and primarily designed to reduce heat loss or gain, and exterior windows, including skylights, and doors) and any energy-efficient heating or cooling equipment or system that can, individually or in combination with other components, meet the standards for the home.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after the date of enactment, and (3) certified in

accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either the 30-percent or 50-percent reduction in energy usage.

Manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2) are met.

The credit is part of the general business credit. No credits attributable to energy efficient homes can be carried back to any taxable year ending on or before the effective date of the credit. No deduction is allowed for that portion of expenses for a qualifying new home otherwise allowable as a deduction for the taxable year which is equal to the amount of the credit for such taxable year. If a credit is allowed for any expenditure, the basis of such property is reduced by the amount of the credit.

Effective Date

The credit applies to homes whose construction is substantially completed after the date of enactment, and which are purchased during the period beginning on the date of enactment and ending on December 31, 2009 (December 31, 2007 in the case of the \$1,000 credit).

3. Deduction for business energy property

Present Law

There is no special deduction provided for energy-efficient property.

Description of Proposal

The proposal provides a deduction for the purchase of qualified energy property. The allowable deduction for each energy property is (1) \$150 for each advanced main air circulating fan or a Tier 1 natural gas, propane, or oil water heater, and (2) \$900 for each Tier 2 energy-efficient building property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, including a fan which uses a brushless permanent magnet motor or another type of motor which achieves similar or higher efficiency at full and half speed, as determined by the Secretary.

A Tier 1 natural gas, propane, or oil water heater is a natural gas, propane, or oil water heater with an energy factor of at least 0.65.

Tier 2 energy-efficient building property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which has a heating seasonal performance factor (HSPF) of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio (EER) of at least 13, (3) a geothermal heat pump which (i) in the case of a closed loop product, has an energy efficiency ratio (EER) of at least 14.1 and a heating coefficient of performance (COP) of at least

3.3, (ii) in the case of an open loop product, has an energy efficiency ratio (EER) of at least 16.2 and a heating coefficient of performance (COP) of at least 3.6, and (iii) in the case of a direct expansion (DX) product, has an energy efficiency ratio (EER) of at least 15 and a heating coefficient of performance (COP) of at least 3.5, (4) a central air conditioner which has a seasonal energy efficiency ratio (SEER) of at least 15 and an energy efficiency ratio (EER) of at least 13, and (5) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80.

The proposal also provides a deduction for energy efficient residential rental building property. The deduction with respect to each dwelling unit is \$6,000 if the building achieves a 50 percent reduction in energy costs relative to the original condition of the building. In the case of a building that achieves a reduction in energy costs between 20 and 50 percent, the allowable deduction is \$12,000 times the percentage reduction. No deduction is allowed in the case of energy cost savings of less than 20 percent. With respect to property potentially eligible for the specific deductions delineated above or for the residential rental building property deduction, the taxpayer must elect which deduction the property is eligible for. In order to be eligible for the credit, the building's energy savings must be certified according to regulations established by the Secretary that follow various rules and procedures. In the case of energy efficient residential rental building property which is public property, the Secretary shall promulgate a regulation to allow the allocation of the deduction to the person primarily responsible for designing the improvements to the property in lieu of the public entity which is the owner of such property.

If a deduction is allowed under this proposal with respect to any property, the basis of such property is reduced by the amount of the deduction so allowed.

Effective Date

The credit applies to property placed in service after the date of enactment and prior to January 1, 2009.

4. Credit for non-business energy property

Present Law

There is no credit provided for non-business energy-efficient property.

Description of Proposal

The proposal provides a credit for the purchase of qualified energy property. The allowable credit is (1) \$50 for each advanced main air circulating fan or Tier 1 natural gas, propane, or oil water heater, and (2) \$300 for each Tier 2 energy efficient property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, including a fan which uses a brushless permanent magnet motor or another type of motor which achieves similar or higher efficiency at full and half speed, as determined by the Secretary.

A Tier 1 natural gas, propane, or oil water heater is a natural gas, propane, or oil water heater with an energy factor of at least 0.65.

Tier 2 energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which has a heating seasonal performance factor (HSPF) of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio (EER) of at least 13, (3) a geothermal heat pump which (i) in the case of a closed loop product, has an energy efficiency ratio (EER) of at least 14.1 and a heating coefficient of performance (COP) of at least 3.3, (ii) in the case of an open loop product, has an energy efficiency ratio (EER) of at least 16.2 and a heating coefficient of performance (COP) of at least 3.6, and (iii) in the case of a direct expansion (DX) product, has an energy efficiency ratio (EER) of at least 15 and a heating coefficient of performance (COP) of at least 3.5, (4) a central air conditioner which has a seasonal energy efficiency ratio (SEER) of at least 15 and an energy efficiency ratio (EER) of at least 13, and (5) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80.

The proposal also provides a credit for highly energy efficient principal residences. The credit with respect to a principal residence is \$2,000 if the principal residence achieves a 50 percent reduction in energy costs relative to the original condition of the building. In the case of a principal residence that achieves a reduction in energy costs between 20 and 50 percent, the allowable credit is \$4,000 times the percentage reduction. No credit is allowed in the case of energy cost savings of less than 20 percent. With respect to property potentially eligible for the specific credits delineated above or for the principal residence credit, the taxpayer must elect which credit the property is eligible for. In order to be eligible for the credit, the residence's energy savings must be certified according to regulations established by the Secretary that follow various rules and procedures.

Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. Certain restrictions and limitations apply with respect to property financed by subsidized energy financing or obtained through grant programs. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account. If a credit is allowed under this proposal with respect to any property, the basis of such property is reduced by the amount of the credit so allowed.

Effective Date

The credit applies to property placed in service after December 31, 2005, and prior to January 1, 2009.

5. Energy credit for combined heat and power system property

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a

structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Description of Proposal

The proposal provides a 10-percent credit for the purchase of CHP property.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) that has an electrical capacity of not more than 15 megawatts or a mechanical energy capacity of no more than 2000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

Additionally, the proposal provides that systems whose fuel source is at least 90 percent bagasse and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

Effective Date

The credit applies to property placed in service after the date of enactment and before January 1, 2008.

6. Energy efficient appliances

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment: (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat; or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the manufacture of energy-efficient appliances.

Description of Proposal

The proposal provides a credit for the eligible production of certain energy-efficient dishwashers, clothes washers and refrigerators.

The credit for dishwashers applies to dishwashers produced in 2006 and 2007 that meet the Energy Star standards for 2007. The credit amount equals \$3 multiplied by the percentage by which the efficiency of the 2007 standards (not yet known) exceeds that of the 2005 standards. The credit may not exceed \$100 per dishwasher.

The credit for clothes washers equals (1) \$50 for clothes washers manufactured in 2005 that have a modified energy factor (MEF) of at least 1.42, (2) \$100 for clothes washers manufactured in 2005-2007 that meet the requirements of the Energy Star program which are in effect for clothes washers in 2007, or (3) the minimum of (i) \$200 or (ii) \$10 multiplied by the average of the energy and water savings percentages of the 2010 Energy Star standards relative to the 2007 Energy Star standards, for clothes washers manufactured in 2008-2010 that meet the requirements of the Energy Star program which are in effect for clothes washers in 2010.

The credit for refrigerators is based on energy savings and year of manufacture. The energy savings are determined relative to the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. Refrigerators that achieve a 15 to 20 percent energy saving and that are manufactured in 2005 or 2006 receive a \$75 credit.

Refrigerators that achieve a 20 to 25 percent energy saving receive a (i) \$125 credit if manufactured in 2005-2007, or (ii) \$100 credit if manufactured in 2008. Refrigerators that achieve at least a 25 percent energy saving receive a (i) \$175 credit if manufactured in 2005-2007, or (ii) \$150 credit if manufactured in 2008-2010.

Appliances eligible for the credit include only those that exceed the average amount of production from the 3 prior calendar years for each category of appliance. In the case of refrigerators, eligible production is production that exceeds 110 percent of the average amount of production from the three prior calendar years. Proration rules apply in the case of credits for 2005 production.

A dishwasher is any a residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer that satisfies the relevant efficiency standard.

The taxpayer may not claim credits in excess of \$75 million for all taxable years, and may not claim credits in excess of \$20 million with respect to clothes washers eligible for the \$50 credit and refrigerators eligible for the \$75 credit. A taxpayer may elect to increase the \$20 million limitation described above to \$25 million provided that the aggregate amount of credits with respect to such appliances, plus refrigerators eligible for the \$100 and \$125 credits, is limited to \$50 million for all taxable years.

Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit is part of the general business credit.

Effective Date

The credit applies to appliances produced after the date of enactment and prior to January 1, 2011 (January 1, 2008 in the case of dishwashers).

7. Residential solar hot water, photovoltaics and fuel cell property

Present Law

There is no present-law personal tax credit for energy efficient residential property.

Description of Proposal

The proposal provides a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of \$2,000. The

provision also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed \$500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and that generates at least 0.5 kilowatts of electricity. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Effective Date

The credit applies to equipment installed after December 31, 2005, and prior to January 1, 2010.

8. Credit for business installation of qualified fuel cells and stationary microturbine power plants

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

There is no present-law credit for fuel cell or microturbine power plant property.

Description of Proposal

The proposal provides a 30 percent business energy credit for the purchase of qualified fuel cell power plants for businesses. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and generates at least 0.5 kilowatts of electricity. The credit for any fuel cell may not exceed \$500 for each 0.5 kilowatts of capacity.

Additionally, the proposal provides a 10 percent credit for the purchase of qualifying stationary microturbine power plants. A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components which converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less than 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts. The credit is limited to the lesser of 10 percent of the basis of the property or \$200 for each kilowatt of capacity.

The credit is nonrefundable. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

Effective Date

The credit for businesses applies to property placed in service after December 31, 2005, and before January 1, 2010 (January 1, 2009 in the case of microturbines), under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

9. Business solar investment tax credit

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after

December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

Description of Proposal

The proposal increases the 10-percent credit to 30 percent in the case of solar energy property placed in service after December 31, 2005 and before January 1, 2010.

Effective Date

The credit applies to solar energy property placed in service after December 31, 2005 and before January 1, 2010.

D. Alternative Motor Vehicles and Fuels Incentives

1. Alternative vehicle credit

Present Law

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether).³² The maximum amount of the deduction is \$50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction is reduced to 25 percent of the otherwise allowable deduction in 2006 and is unavailable for purchases after December 31, 2006.

Description of Proposal

Alternative motor vehicle credits

The proposal provides a credit for the purchase of a new qualified fuel cell motor vehicle, a new qualified hybrid motor vehicle, and a new qualified alternative fuel motor vehicle. In general the proposal provides that the buyer claims the credit, unless the buyer is a tax-exempt entity in which case the seller or lessor of the vehicle may claim the credit. The taxpayer may carry forward unused credits for 20 years or carry unused credits back for three years (but not to any taxable year beginning before the date of enactment). Qualified vehicles fuel cell motor vehicles are vehicles placed in service before 2015. Qualified hybrid motor vehicles are vehicles placed in service before 2010. Qualified alternative fuel motor vehicles are vehicles placed in service before 2011. Any deduction otherwise allowable under sec. 179A is reduced by the amount of credit allowable.

Fuel cell vehicles

A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes (see below). Table 2, below, shows the proposed base credit amounts.

³² A hybrid-electric vehicle may qualify as a clean-fuel vehicle under present law.

Table 2.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500	\$8,000
8,500 < vehicle ≤ 14,000.....	\$10,000
14,000 < vehicle ≤ 26,000.....	\$20,000
26,000 < vehicle.....	\$40,000

In the case of a fuel cell vehicle weighing less than 8,500 pounds and placed in service after December 31, 2009, the \$8,000 amount in Table 2, above is reduced to \$4,000.

Table 3, below, shows the proposed additional credits for passenger automobiles or light trucks.

Table 3.–Credit for Qualifying Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	At least	but less than
\$1,000	150% of base fuel economy	175% of base fuel economy
\$1,500	175% of base fuel economy	200% of base fuel economy
\$2,000	200% of base fuel economy	225% of base fuel economy
\$2,500	225% of base fuel economy	250% of base fuel economy
\$3,000	250% of base fuel economy	275% of base fuel economy
\$3,500	275% of base fuel economy	300% of base fuel economy
\$4,000	300% of base fuel economy	

Hybrid motor vehicles

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualifying hybrid motor vehicle must be placed in service before January 1, 2010.

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard and a conservation credit based on the estimated lifetime fuel savings of a qualifying vehicle compared to a comparable 2002 model year vehicle. A qualifying hybrid automobile or light truck must have a maximum available power from the rechargeable energy storage system of at least five percent. In addition, the vehicle must meet or exceed certain EPA emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 4, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy.

Table 4.–Fuel Economy Credit

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	At least	but less than
\$400	125% of base fuel economy	150% of base fuel economy
\$800	150% of base fuel economy	175% of base fuel economy
\$1,200	175% of base fuel economy	200% of base fuel economy
\$1,600	200% of base fuel economy	225% of base fuel economy
\$2,000	225% of base fuel economy	250% of base fuel economy
\$2,400	250% of base fuel economy	

In the case of a qualifying hybrid motor vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualifying hybrid motor vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is \$7,500. For a qualifying hybrid motor vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is \$15,000. For a qualifying hybrid motor vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is \$30,000.

A qualifying hybrid motor vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualifying hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle would be 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between \$4,000 and \$32,000 depending upon the weight of the vehicle. Table 5, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class.

Table 5.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating in Pounds	Maximum Allowable Incremental Cost
Vehicle ≤ 8,500	\$5,000
8,500 < vehicle ≤ 14,000	\$10,000
14,000 < vehicle ≤ 26,000	\$25,000
26,000 < vehicle	\$40,000

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel (except in the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy for vehicles by inertia weight class by vehicle type. The “vehicle inertia weight class” is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 6, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 6.—2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class Pounds	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4

Vehicle Inertia Weight Class Pounds	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Effective Date

The proposal is effective for property placed in service after the date of enactment.

2. Electric vehicle credit

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of \$4,000. A qualified electric vehicle generally is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The full amount of the credit is available for purchases prior to 2006. The credit is reduced to 25 percent of the otherwise allowable amount for purchases in 2006 and is unavailable for purchases after December 31, 2006.

Description of Proposal

The proposal repeals the phaseout of the credit under present law. The proposal also modifies present law to provide for a credit equal to the lesser of \$1,500 or 10 percent of the manufacturer's suggested retail price of certain vehicles that conform to the Motor Vehicle Safety Standard 500. For all other electric vehicles, Table 7, below describes the credit.

Table 7.—Credit for Qualifying Battery Electric Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500	\$4,000
8,500 < vehicle ≤ 14,000.....	\$10,000
14,000 < vehicle ≤ 26,000.....	\$20,000
26,000 < vehicle.....	\$40,000

If an electric vehicle weighing not more than 8,500 pounds has an estimated driving range of at least 100 miles on a single charge of the vehicle’s batteries or if it is capable of a payload capacity of at least 1,000 pounds, then the credit amount in Table 7 is \$6,000.

In the case of property purchased by tax-exempt persons, the seller may claim the credit. The proposal allows taxpayers to carry forward unused credits for 20 years or carry unused credits back for three (but not to any taxable year before the date of enactment).

Effective Date

The proposal is effective for property placed in service after the date of enactment and before January 1, 2010.

3. Alternative fuel refueling property credit

Present Law

Clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to \$100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. The deduction is unavailable for costs incurred after December 31, 2006.

For the purpose of sec. 179A clean fuels comprise natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether.

Description of Proposal

The proposal permits taxpayers to claim a 50-percent credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property the allowable credit may not exceed \$30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed \$1,000.

Under the proposal clean fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, and hydrogen.

The taxpayer's basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed. In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2010. The credit allowable for any taxable year cannot exceed the amount by which the taxpayer's regular tax (reduced by certain other credits) exceeds the taxpayer's tentative minimum tax. The taxpayer may carry forward unused credits for 20 years.

In the case of hydrogen fuel refueling property, to be eligible for the credit, the property must be placed in service before January 1, 2015.

Effective Date

The proposal is effective for property placed in service after the December 31, 2005.

4. Volumetric excise tax credit for alternative fuels

Present Law

A 24.3-cents-per-gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund. Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund.³³ The statutory rates for certain special motor fuels and compressed natural gas are determined on an energy equivalent basis, as follows:

³³ Sec. 4041(a)(2)(A)(i). An additional 0.1 cent per gallon tax is imposed for the Leaking Underground Storage Tank Trust Fund on the sale or use of any liquid (other than liquefied petroleum gas and other than liquefied natural gas) if any tax was applicable under section 4041(a)(1) (relating to diesel fuel and kerosene) or 4041(a)(2) (relating to special motor fuels). See sec. 4041(d).

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

Under section 4041, tax is imposed on special motor fuels (any liquid other than gas oil, fuel oil or any product taxable under section 4081) when there is a taxable sale by any person to an owner, lessee or other operator of a motor vehicle or motorboat, for use as fuel in the motor vehicle or motorboat or used by any person as a fuel in a motor vehicle or motorboat unless there was a prior taxable sale. No excise tax credit is provided for the sale or use of those fuels.

Liquid hydrogen, when sold or used as fuel in a motor vehicle or motorboat, is a special motor fuel for purposes of the tax on special motor fuels and would be subject to tax at 18.4 cents per gallon.³⁴ Compressed hydrogen gas used or sold as a fuel is not subject to tax.

Prior to the American Jobs Creation Act of 2004, gasohol and gasoline to be blended into gasohol was taxed at a reduced rate based on the amount of ethanol contained in the mixture (e.g., 10 percent, 7.7 percent or 5.5 percent alcohol in the mixture). The Act eliminated reduced rates of excise tax for most alcohol-blended fuels. In place of the reduced rates, the Act amended the Code to create two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.³⁵ The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). A person may also file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture.³⁶ The credits and payments are paid out of the General Fund. If the alcohol is ethanol with a proof of 190 or greater, the credit or payment amount is 51 cents per gallon. For agri-biodiesel, the credit or payment amount is \$1.00 per gallon; for biodiesel other than agri-biodiesel, the credit or payment amount is 50 cents per gallon. Under the Code's coordination rules, a claim may be taken only once with respect to any particular gallon of alcohol or biodiesel.

Description of Proposal

Under the proposal, the liquefied petroleum gas, and P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)) are taxed at 18.3 cents per gallon under section 4041. Compressed natural gas is taxed at 18.3 cents per energy equivalent of a gallon of gasoline, and liquefied natural gas, any liquid fuel derived from coal and liquid hydrocarbons

³⁴ This includes an additional 0.1 imposed by section 4041(d) for the Leaking Underground Storage Tank Trust Fund.

³⁵ Sec. 6426. The Act also created an income tax credit for biodiesel and biodiesel mixtures. Sec. 40A.

³⁶ Sec. 6427(e).

derived from biomass would be taxed at 24.3 cents per gallon under section 4041. Under the proposal, hydrogen (whether in liquid or gas form) is exempt from the tax imposed by section 4041, however, persons selling hydrogen as fuel for motor vehicles or motorboats are required to register with the Secretary. Collectively, these fuels (including hydrogen) are referred to as “alternative fuels.”

In addition, the proposal creates two new excise tax credits, the alternative fuel credit, and the alternative fuel mixture credit. The credits are allowed against section 4041 liability. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a highway vehicle. The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. The mixture must be sold by the taxpayer for use as a fuel in a highway vehicle or used by the taxpayer for use as a fuel in a highway vehicle. Liquid fuel derived from coal would only qualify for the credits if derived from the Fischer-Tropsch process. The credits generally expire after September 30, 2009. The proposal also allows persons to file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after September 30, 2009. Both credits and payments are made out of the General Fund. Under coordination rules, a claim for payment or credit may only be taken once with respect to any particular gallon or gasoline-gallon equivalent of alternative fuel.

With respect to hydrogen, the credit and payment provisions expire after December 31, 2014.

Effective Date

The proposal is effective for any sale, use or removal for any period after September 30, 2006.

5. Extend excise tax provisions and income tax credit for biodiesel

Present Law

Biodiesel income tax credit

Overview

The Code provides an income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit.³⁷ The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit may not be carried back to a taxable year ending before or on December 31, 2004. The provision does not apply to fuel sold or used after December 31, 2006.

³⁷ Sec. 40A.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel which identifies the product produced and the percentage of the biodiesel and agri-biodiesel in the product.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is \$1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of biodiesel which is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is \$1.00 per gallon.

Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.³⁸ The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is \$1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.³⁹

³⁸ Sec. 6426(c).

³⁹ Sec. 6426(c)(4).

The credit is not available for any sale or use for any period after December 31, 2006. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.⁴⁰ To the extent the biodiesel fuel mixture credit exceeds any section 4081 liability of a person, the Secretary is to pay such person an amount equal to the biodiesel fuel mixture credit with respect to such mixture.⁴¹ Thus, if the person has no section 4081 liability, the credit is refundable. The payment provision does not apply with respect to biodiesel fuel mixtures sold or used after December 31, 2006.

Description of Proposal

The proposal extends the income tax credit, excise tax credit, and payment provisions through December 31, 2010.

Effective Date

The proposal is effective on the date of enactment.

⁴⁰ Sec. 6427(e).

⁴¹ Sec. 6427(e)(2). See also, Internal Revenue Service, *Notice 2005-4*, 2005-2 I.R.B. (December 15, 2004).

E. Energy Related Technical Corrections

1. Technical corrections relating to the expansion of the credit for electricity produced from certain renewable resources

The technical correction provides that the five-year credit period applicable to open-loop biomass facilities that were originally placed in service before the date of enactment begins on January 1, 2005.

The technical correction clarifies that open-loop biomass resources include both cellulosic and lignin waste material.

The technical correction strikes as deadwood the credit eligibility rule for government-owned poultry waste facilities, as such facilities placed in service after the date of enactment are provided for under the rules for agricultural livestock waste nutrient facilities.

The technical correction clarifies that, for the purpose of section 45, a qualified landfill gas facility does not include a facility that uses gas that was produced at a facility, the production from which is, or was previously, allowed a credit under section 29 for the production of landfill gas.

The technical correction clarifies that the Act did not change the determination of whether property is eligible for a five-year recovery period under section 168(e)(3)(B)(vi)(I).

The technical correction provides that the poultry waste facilities placed in service on or before the date of enactment are unaffected by the new provision relating to agricultural livestock waste nutrient facilities.