

# The Greening Code

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For all its warts and blemishes, the Internal Revenue Code (“the Code”) can—and perhaps should—be viewed as a mirror of the American taxpayers whose lives it governs. Most taxpayers today may believe some sort of progressive income redistribution is appropriate. The Code should generally reflect these beliefs. Despite the flat tax pundits and VAT advocates, a graduated income tax appears to be a core principle of our beliefs about the fisc and one that will not disappear from the Code anytime soon.

But the Code is clearly not a static document. As our societal mores and norms change, the Code changes too. One of the many evolutions in the Code involves the increased use of tax credits and other incentives to create a more environmentally sustainable and efficient society. Such changes can be viewed as Pigovian in character.

Named for British economist Arthur C. Pigou, Pigovian taxes are generally intended to influence behavior. For example, a Pigovian tax might include a levy on the polluting agent equal to marginal social damage. [See

Maureen L. Cropper and Wallace E. Oates, *Environmental Economics: A Survey*, 30 J. ECON. LITERATURE 675, 680 (1992).] A federal Pigovian gasoline tax might be imposed at such a rate to reduce American gasoline consumption to an efficient level.

In so doing, such a tax might be used to decrease national spending (and income taxes). It might also be used to ameliorate the damage caused by automobiles and other gas consumers. [See Evan N. Turgeon, *Triple-Dividends: Toward Pigovian Gasoline Taxation* 30 J. LAND RESOURCES & ENVTL. L. 145, 146 (2010).]

### Green Thumbs Everywhere

A survey of the various environmental tax incentives available throughout the Code and other federal statutes shows that increasingly taxpayers have many reasons to green their lives. Section 1603 of the American Recovery and Reinvestment Act of 2009, P.L. 111-5, 123 Stat. 115 (2009), is one instance of the tax incentives available to individuals and entities willing to adopt efficient energy technology.

Section 1603 of the American Recovery and Reinvestment Act ("Act Sec. 1603") did not amend or enact a particular section of the Code. Rather, it provides cash payments to individuals and selective entities that acquired "specified energy property" as described at Code Secs. 45 and 48.

Among others, these green energy properties include the following:

- Facilities using wind to produce electricity
- Facilities using geothermal or solar energy to produce electricity
- Hydroelectric dams
- Facilities producing energy derived from waves, tides and currents in oceans, and free flowing water in rivers, lakes and streams

In general, the green energy property must be used in a trade or business. But in certain instances, even property used by a taxpayer at his personal residence may be the subject of an Act Sec. 1603 payment.

### Free Money for Green Machines

Act Sec. 1603, as amended by Section 707 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, empowers the Treasury

to provide cash payments. Who gets them? Certain persons who purchase the properties listed above and place them in service during 2009, 2010 and 2011.

But the payments may continue in subsequent tax years. The House Science, Space and Technology subcommittee recently met to decide whether to extend such Act Sec. 1603 grants into 2012. Currently, it remains unclear whether such continuing governmental financial incentives will be forthcoming.

In general, under Act Sec. 1603, the Treasury will reimburse qualified applicants in an amount equal to 10 or 30 percent of the basis of the above listed properties, depending on the type of property. Importantly, Act Sec. 1603 does not involve tax credits, special accelerated depreciation, or some other return computation affecting the taxpayer's taxable income. Rather, for most taxpayers, Act Sec. 1603 is quite literally a handout from the federal government to purchase and place in service environmentally friendly equipment.

Act Sec. 1603 payments are available to most taxpayers. However, certain entities—in effect, nontaxpayers—are not allowed the Act Sec. 1603 grants. For example, federal, state and local governments are not eligible for payment. Similarly, schools, colleges and universities that are 501(c)(3) organizations are not privy to the grants.

### Green Guidance

The IRS recently released guidance in the form of Notice 2012-23 (Mar. 12, 2012) on the tax issues arising under Act Sec. 1603. As with many of the other pieces of guidance recently promulgated by the IRS, this notice is in the form of frequently asked questions (FAQs). These FAQs show the scope and ambition of this program.

Most significantly, the IRS points out that an Act Sec. 1603 payment is *not includible* in a taxpayer's gross income. [See FAQ 1.] In addition, taxpayers effectively receive free basis for purposes of depreciation with their Act Sec. 1603 payment. While the grant recipient must reduce his basis in the green energy equipment by 50 percent of the Act Sec. 1603 payment, the other 50 percent of the grant can be capitalized as included in the cost basis of the property for purposes of depreciation. [See *id.*]

For investors, Act Sec. 1603 payments are also available. Let's say there is a partnership that owns property and has a tax-exempt entity as a partner. Of course, tax-exempt entities, including Code Sec. 501(c)(3) entities, generally cannot receive the Act Sec. 1603 grants.

However, according to the IRS guidance, the existence of a tax-exempt partner will not necessarily prevent the partnership from obtaining an Act Sec. 1603 payment. [See FAQ 3.] Provided the special depreciation allocations are observed, the existence of such a tax-exempt partner will not bar the partnership from receiving and reaping the tax-exempt benefit of an Act Sec. 1603 payment. In addition, prior guidance from the IRS makes clear that even a partnership that has a foreign entity as a partner—potentially an exempt entity—may still be eligible for an Act Sec. 1603 payment.

Finally, even if the taxpayer engages in some sort of SILO or LILO transaction, it is conceivable that he may retain the Sec. 1603 grant. [See FAQ 5.] The FAQs indicate that

if the renewable energy project is sold and leased back more than three months after being placed in service, the lessor and lessee may elect to pass through the Act Sec. 1603 payment to the lessee. In such cases, the lessor does not reduce basis by 50 percent of the amount of the Act Sec. 1603 payment. The lessee must agree to include in gross income ratably over the five-year recapture period an amount equal to 50 percent of the amount of the Act Sec. 1603 payment.

### Conclusion

The Code provides many tax incentives for taxpayers who are willing to pick the low-hanging fruit. While numerous provisions provide advantages for taxpayers, tax-free cash payments are unusual. Act Sec. 1603 payments seem like a boon to any taxpayer, regardless of his or her interest in renewable energy. It remains unclear what the future of Act Sec. 1603 will be, but Pigovian or otherwise, such provisions may make environmentalists of all of us.

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