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GEORGIA AND FEDERAL ENERGY TAX CREDITS, GRANTS AND FINANCING

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In a very short time period, the Federal Government and the State of Georgia have adopted or expanded a number of income tax credits, grants and subsidized financing programs that are available for renewable energy projects. The following is a brief overview of the new federal and Georgia tools available to assist and encourage renewable energy projects in Georgia.

I. Federal Tax Credits

The Investment Tax Credit (the "Investment Energy Credit") authorized by Section 48 of the Internal Revenue Code (the "Code") and the Production Tax Credit (the "Production Credit") authorized by Section 45 of the Code have been the federal income tax credit incentives for the installation and operation of renewable energy projects. The American Recovery and Reinvestment Act of 2009 ("ARRA") has made both types of credits (but particularly the Investment Energy Credit) even more attractive to use, because taxpayers developing and investing in renewable energy facilities can realize more value from the credits and also now have more options in structuring these transactions. Following on the favorable amendments set forth in last October's Energy Improvement and Extension Act of 2008 ("EIEA"), the federal government is providing additional incentives for the rapid development of renewable energy facilities such as solar photovoltaic panels, solar thermal heating, photovoltaic generation facilities, wind farms, geothermal and other alternative energy technologies.

The Investment Energy Credit historically has been available primarily to taxpayers owning or investing in solar electric and heating equipment. The amount of the Investment Energy Credit is generally 30 percent of the "Eligible Cost Basis" of the subject facilities, with no maximum limit on the dollar amount of the credits. The basis consists of the aggregate cost of the investment to the taxpayer, regardless of how much electricity is actually produced or sold from the facility – if any. The requirement is simply that funds be invested in a facility that is "placed in service" and generates electricity for heating, cooling or lighting. Typical ancillary installations or equipment such as transmission lines or substations are not included when calculating the eligible basis; however, a reasonable development fee can be included. Although the full amount of the Investment Energy Credit is available in the year in which the facility is actually placed in service, this credit vests at 20% per year, so recapture of the credits received is possible if the facility is sold or otherwise disposed of during the first five years after it is placed in service.

For many other renewable energy sources, such as large-scale wind, geothermal, biomass and other non-solar energy production facilities, the Production

Credit has been the traditional primary incentive available to the developer. A potential negative aspect of the Production Credit is that, as its name implies, the amount of credit is a function of the amount of electricity produced by the facility. ARRA, however, now permits the owner of a facility otherwise eligible for the Production Credit to elect to use the Investment Energy Credit instead, thereby permitting the amount of the credit to be determined solely by reference to the cost basis of the facility as opposed to its actual electricity production.

Before the EIEA, it was necessary for a facility to be placed in service before January 1, 2009 in order to be eligible for the Investment Energy Credit, and Production Credits were only available for projects placed in service before 2011 or earlier, depending upon the type of facility involved. Last fall, the EIEA extended the placed in service deadline for purposes of the Investment Energy Credit to December 31, 2016. ARRA has also extended the placed in service deadline for projects claiming Production Credits to 2012 for wind facilities and 2013 for other projects eligible for Production Credits.

Another significant improvement under ARRA is the elimination of the so-called "subsidized financing penalty" for purposes of the Investment Energy Credit. Previously, the use of state bonds, grants, below market loans, various forms of other "subsidized financing" or other types of tax credits would reduce the eligible basis of the property (and thus, the allowable credits) pro rata, based on the percentage of the facility using or benefitting from the installations funded with the deemed subsidy. This has now been repealed under ARRA for purposes of the Investment Energy Credit. Taxpayers can now calculate the credit by reference to the full Eligible Cost Basis of the facility, regardless of the existence and type of other financing sources including state and local grants. This has the potential of increasing the economic value of these credits by 30-50% and makes them useable in a much wider range of projects already receiving favorable government financing through tax-exempt bonds (such as Recovery Zone Facility Bonds) or certain HUD programs. It should be noted, however, that the amount of Eligible Cost Basis of property for the Production Credit continues to be subject to reduction as a result of grants and other subsidies that are financing sources for such projects. ARRA did not modify these subsidy rules as they relate to the Production Credit.

Although the Owner of the facility is typically the party that claims the Investment Energy Credit or the Production Credit, the parties who actually develop and operate a facility often do not have sufficient taxable income to benefit from claiming the credits. Also, because ARRA did not change the passive loss rules for individual taxpayers with respect to the credits, the value of the credits to individuals remains limited. The ownership of renewable energy facilities can be structured, however, so that they are owned and operated through a master lease structure or by one or more entities that are treated as a partnership for federal income tax purposes. An investor or a fund composed of a group of investors can be admitted as a partner that contributes a significant portion of the capital used to pay for the construction of the facility (and the payment of an appropriate developer fee to the developer). The contributing investor partner then receives an allocation of substantially all of the tax credits for which the project is eligible. The amount of the capital contribution from the investor partner generally corresponds to the amount of credits being allocated.

There are myriad tax and business issues, and accompanying documentation costs, associated with structuring transactions so as to deliver the maximum amount of credits to the investor. One primary concern is that the credits must be allocated in accordance with the "profits interest" of the partners in a partnership, meaning that for an investor to receive 99% or more of the credits allocated to that investor, the investor must own a 99% or more profits interest. A variety of subsidiary issues also arise in the context of structur-

ing the ownership so as to satisfy the "profits interest" requirement while at the same time achieving the developer's goal of receiving the maximum flow of cash distributions and compensation paid from the operation of the facility.

After ARRA, however, the developer has an additional option that enables it to perhaps avoid the need to restructure the ownership to deliver credits to an investor as a means for raising capital. ARRA now allows the owner to choose either (1) the Investment Energy Credit or the Production Credit, or (2) to elect to "monetize" the credits by receiving a payment from the federal government, which is somewhat confusingly referred to as a "grant." These payments should not be confused with the ARRA grants available through the State of Georgia (described below under "Georgia Grants from ARRA Funds").

The amount of this grant is equal to 30 percent of the qualified tax basis of most types of renewable energy facilities, with no overall dollar limit. This is especially advantageous to entrepreneurial developers who do not have the need for the credits themselves and cannot find a suitable tax credit investor partner. The grant only works, however, for projects that are ready to go forward in the next couple of years. In order to obtain this type of grant, an application must be filed with the Treasury Department by October 1, 2011, construction of the project must have begun before the end of 2010 and the facility must be placed in service by a specified deadline of December 31, 2012 for wind facilities eligible for the Production Credit; December 31, 2013 for all other facilities eligible for the Production Credit and December 31, 2016 for facilities eligible for the Investment Energy Credit.

These payments from the U.S. government are not paid out until 60 days after the later of the date the facility is placed in service or the grant application date. Because a developer will not receive the grant funds in any event until the facility is completed, it will be necessary to use some sort of bridge financing to finance construction needs. The ARRA conference agreement indicates that if the taxpayer elects to receive a grant, it will not be included in taxable income; however, the tax basis of the property will be reduced in an amount equal to 50% of the grant.

II. Georgia Tax Credits

In addition to the federal tax credits described above, in 2008 Georgia adopted its own income tax credits for investments in "clean energy property." O.C.G.A. 48-7-29.14. Clean energy property includes:

(A) A wide array of solar energy equipment,
(B) Energy Star certified geothermal heat pump systems,
(C) Energy efficient projects such as lighting retrofit projects and energy efficient buildings,
(D) Wind energy equipment, and
(E) Biomass equipment to convert wood residuals into electricity through gasification and pyrolysis.

For property for other than single family residential purposes, the Georgia tax credit is limited to the <u>lesser</u> of 35% of the cost of the clean energy property <u>or</u>

(i) $500,000 per installation to solar energy, solar thermal electric applications, wind and biomass equipment,

(ii) $100,000 per installation for domestic water heating,
(iii) $100,000 for Energy Star certified geothermal heat pump systems,
(iii) $.60 per square foot of the building for a lighting retrofit project with a maximum of $100,000, and
(iv) $1.80 per square foot of the building for an energy efficient building project with a $100,000 maximum.

In essence, the tax credits for solar energy, solar thermal applications, wind and biomass equipment are capped at $500,000 and the remainder are capped at $100,000.

For property for single family residential purposes, the Georgia tax credit is limited to the lesser of 35% of the cost or

(i) $2,500 per dwelling unit for domestic water heating systems,
(ii) $10,500 per dwelling unit for solar electric (photovoltaic) or thermal electric applications, active space heating or wind projects, and
(iii) $2,000 per installation of Energy Star certified geothermal heat pump systems.

If the credits exceed a Georgia taxpayer's income tax liability, the excess Georgia tax credits can be offset against the taxpayer's Georgia payroll withholding taxes.

The Georgia tax credits are available on a first come, first served basis. Unfortunately, under current law, the total Georgia tax credits to all taxpayers is limited to $2,500,000 for each of the 2008-2012 tax years.

The Georgia tax credits can be combined with the Federal tax credits. The Georgia tax credits are not refundable or generally transferrable. Georgia tax credits cannot be claimed for property obtained with the Georgia grants of ARRA funds.

III. Georgia Grants of ARRA Funds

Georgia is eligible for approximately $82.5 million in ARRA funding for its State Energy Program (SEP) and $124.8 million for its low-income home Weatherization Assistance Program (WAP). In addition, large Georgia Counties and Cities are directly eligible for approximately $45.5 million of Energy Efficiency and Conservation Block Grants (EECBGs). Smaller Georgia Counties and Cities are eligible for approximately an additional $21.6 million.

The SEP and WAP funds and the $21.6 million of the EECBGs available to smaller Counties and Cities will be administered by the Georgia Environmental Facilities Authority (GEFA).

SEP GRANTS

The allocation of the SEP grant funds will be as follows:

- State Facilities Retrofit Program - $65,000,000
- Clean Energy Project Grant Program (HB473) - $4,495,000
- Renewable Energy Grants - $4,000,000
- Commercial Energy Efficiency Grants - $2,000,000
- Industrial Energy Efficiency Grants - $2,000,000
- Residential Energy Efficiency Grants - $2,000,000
- Governor's Energy Challenge - $1,008,052
- Energy Building Codes Update and Compliance - $1,000,000 and
- Program Management - $991,948.

Grants will be awarded through an open, competitive application process. **GEFA has announced that the applications process for SEP funds will not begin until the Federal Department of Energy has approved Georgia's SEP plan and awarded the ARRA funds to GEFA, which is expected no earlier than July 12, 2009.**

Over 78% of the SEP grants will be used for the State Facilities Retrofit Program. Private sector organizations may apply for the following:

- Clean Energy Property Grants
- Renewable Energy Grants
- Commercial Energy Efficiency Grants
- Industrial Energy Efficiency Grants, and
- Residential Energy Efficiency Grants.

On May 13, GEFA published a release which describes the Plan for the State Energy and Weatherization Programs. The release describes the focus of the private sector grants in additional detail. A copy is attached.

Georgia Clean Energy Property Grants

The Governor recently signed HB 473 (new O.C.G.A. 50-23-21) which provides a framework for the Georgia $4,495,000 Clean Energy Property Grant Program which is a part of Georgia's SEP Grant program. The definition of the "clean energy property" for which the grants can be used and the limits for the Clean Energy Property Grants are the same as those for the Georgia energy tax credits described above, except "business equipment to convert wood residuals into electricity through gasification and pyrolysis" is deleted. Recipients of such grants may not claim a Georgia clean energy property tax credit for the same property. The clean energy property must be placed in service before December 31, 2012. The grants can be used in combination with the Federal tax credits described above.

Georgia's Clean Energy Property Grants will be awarded on a first come, first served basis; however, the application process is not expected to begin before July 12, 2009

WAP

WAP is an energy conservation program for low-income individuals. The maximum expenditure for weatherization services per household is $6,500. GEFA will administer the WAP Grants.

Energy Efficiency and Conservation Block Grants

Cities with population of less than 35,000 and Counties with population of less than 200,000 will apply to GEFA for EECBGs up to a total of approximately $21.6 million. Larger Cities and Counties will apply directly to the Energy Efficiency and Renewable Energy Office of the U.S. Department of Energy for a total of approximately $45.6 million of such grants. A list of Georgia's larger Cities and Counties and their estimated formula allocations is attached.

IV. Recovery Zone Bonds

The American Recovery and Reinvestment Act of 2009 (the "ARRA") created two new categories of bonds which can be used to finance a wide range of projects, including renewable energy projects, real estate developments and public infrastructure:

A. RECOVERY ZONE FACILITY BONDS ("RZFBs"), and

B. RECOVERY ZONE ECONOMIC DEVELOPMENT BONDS ("RZEDBs"), a category of Build America Bonds.

USE OF RZFBs and RZEDBs

To support the active conduct of a qualifying business, including most renewable energy projects,n real estate development projects, it is possible in 2009 and 2010 for a County or Large Municipality, or any entity empowered to issue bonds on its behalf, to issue one or both (1) RZFBs to finance the capital costs of privately owned or utilized business facilities and a wide range of renewable energy and real estate development projects within a Recovery Zone; and (2) RZEDBs to finance, for example, public infrastructure (water, sewer, roads, traffic lights, power generation etc.) within a Recovery Zone.

- A "Recovery Zone" ("RZ") means:

  (1) any area designated by the bond issuer as having significant poverty, unemployment, sale of home foreclosures, or general distress;

  (2) any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990; or

  (3) any area which is a federal Empowerment Zone or Renewal Community.

- In Public Notice 2009-50 (the "Public Notice") the Internal Revenue Service (the "IRS") stated that any State, County or Large Municipality may make designations of RZs, "in any reasonable manner as it shall determine in good faith in its discretion." The Public Notice is available by going to www.irs.gov, then clicking on the "Tax Exempt Bond Community" bar at the top right of the page, and then clicking on "Notice 2009-50 (Recovery Zone Bond Volume Cap Allocations)."

- The RZFBs and RZEDBs must be issued on or before December 31, 2010.

- The nationwide limits are:

RZFBs	$15 Billion
RZEDBs	$10 Billion

- Georgia's RZFBs allocation is $533,677,000. Georgia's allocation for RZEDBs is $355,785,000. The IRS allocation list was published June 12.

- Eligible Issuers of RZ Bonds include states, political subdivisions such as Counties and Large Municipalities, and entities empowered to issue bonds on behalf of any such governments, such as Development Authorities (the "Authorities").

BACKGROUND

State and local governments can issue either governmental bonds or private activity bonds. Governmental bonds are issued by governments to finance governmental functions (public purposes) and are repaid with governmental funds. State and local governments can also serve as financing conduits by providing financing to private, nongovernmental borrowers ("Private Activity Bonds").

Generally the interest received by bondholders of governmental bonds is excluded from gross income for federal income tax purposes. The federal government thereby provides an indirect subsidy to state and local governments. The interest exclusion is also available to holders of some limited categories of Private Activity Bonds referred to as "Qualified Private Activity Bonds." Small Issue ($10 million limit) Industrial Development Bonds are a familiar example.

The ARRA creates two additional methods of federally subsidized financing for economic development: RZFBs and RZEDBs.

WHAT ARE THE ADVANTAGES OF RZFBs?

RZFBs are treated as Exempt Facility Bonds. The interest on Exempt Facility Bonds is excluded from gross income for federal income tax purposes. Exempt Facility Bonds can be utilized to finance certain types of privately owned facilities. For example, Counties and Large Municipalities or their Authorities could issue tax exempt bonds and loan the bond proceeds to privately owned companies for "Recovery Zone Property."

RZFBs could substantially reduce the costs of financing for certain privately owned facilities.

FOR WHAT CAN RZFBs BE USED?

RZFBs can be used to finance Recovery Zone Property. Recovery Zone Property means depreciable property (for example, land, building, equipment), including property expensed under Internal Revenue Code Section 179, if:

(1) the property was constructed, reconstructed, or acquired by purchase by the taxpayer after the designation of the RZ took effect;

(2) the original use of the property within the RZ commences with the taxpayer;

(3) substantially all the property is in a RZ; and

(4) the property is used in the active conduct of a "Qualified Business" by the taxpayer in the RZ.

Property which is substantially renovated by a taxpayer meets requirements (1) and (2) above. Property is treated as substantially renovated by a taxpayer if, during any 24-month period (the "Period") beginning after the designation of the RZ took effect, additions to the basis of the property in the hands of the taxpayer exceed the adjusted basis of the property at the beginning of the Period in the hands of the taxpayer.

Used property in a RZ does not qualify as Recovery Zone Property; but used property purchased outside a RZ may quality as Recovery Zone Property if its original use within the RZ commences with the taxpayer.

A "Qualified Business" is any trade or business other than

(a) rental residential property or

(b): (1) a golf course
(2) a country club
(3) a massage parlor
(4) a hot tub facility
(5) a sun tan facility
(6) a race track
(7) a gambling facility, or
(8) any store the principal business of which is the sale of alcoholic beverages for consumption off premises (a liquor store).

RZFBs can be used for a wide range of projects including, for example, renewable energy projects, office buildings, distribution centers, manufacturing facilities, retail developments, industrial and business parks, call centers, and research and development facilities.

RZFBs have a number of advantages over Qualified Small Issue Bonds (sometimes referred to as "Industrial

Development Bonds"), including:

1. can be used to finance almost any business facility or real estate development,
2. no $10,000,000 per project limitation on the principal amount of the bonds,
3. no $20,000,000 per project capital expenditures limit, and
4. not subject to the normal annual State by State numerical limitation on Private Activity Bonds issued in that year (overall volume cap).

ARRA has made two other changes which will expand the market for RZFBs:

1. RZFBs are not subject to the Alternative Minimum Tax, and
2. A bank or a financial institution may deduct 80% of its cost of funding for tax-exempt obligations, including RZFBs, up to 2% of its total assets.

Financing a project with RZFBs **will not cause** that project to be subject to the prevailing wage requirements of the Davis-Bacon Act.

WHAT IS THE ADVANTAGE OF RZEDBs?

The County or Large Municipality, or its Authority, as issuer of RZEDBs can elect to:

A. Issue the bonds as Tax Exempt Bonds. The interest income received by the bondholder is excluded from the bondholder's gross income for federal income tax purposes,

B. Issue the bonds as Build America Bonds (Tax Credit). The issuer does not pay interest to the bondholder. The bondholder receives a 35% nonrefundable tax credit against federal income taxes; but must include the amount of the credit in his gross income for federal income tax purposes,

C. Issue the bonds as Build America Bonds (Direct Payment). The bondholder receives taxable interest and no tax credit. The state or local government irrevocably elects to receive a direct cash payment from the U.S. Treasury of 35% of the interest payable on the bonds on each interest payment date, **or**

D. Issue the bonds as RZEDBs (Direct Payment). The same rules as those for Build America Bonds (Direct Payment) apply, except the direct payment from the U.S. Treasury to the issuer is 45% of the interest payable on the RZEDBs.

RZEDBs should reduce the costs of financing and appeal to a broader pool of investors, especially those investors who have no current need or use for federal income tax credits or income excluded from gross income. The market for taxable bonds is much larger than the market for tax exempt bonds.

FOR WHAT CAN RZEDBs BE USED?

RZEDBs can be used for any "Qualified Economic Development Purpose," which means expenditures by a County or Large Municipality, or its Authority, for the purpose of promoting development or other economic activity in a RZ, including the following:

(1) capital expenditures paid or incurred with respect to property located in the RZ;

(2) expenditures for public infrastructure and construction of public facilities (which could include power generation and distribution); and

(3) expenditures for job training and educational programs.

RZEDBs can be used for a wide variety of public projects, such as power generation and distribution facilities and equipment, water and waste water treatment plants, roads, rail sidings, water towers, industrial parks, and storm water systems.

RZEDBs can not be used (a) to finance private activities or privately owned facilities, or (b) for refinancing existing debt.

The prevailing wage requirements of the Davis-Bacon Act **will apply** to any project financed with the proceeds of any RZEDB.

UTILITY AND GUIDANCE

- Please note that (1) the RZFB or RZEDB amounts allocated and available to a particular County or Large Municipality may not be significant when compared to the total cost of a particular project and (2) the RZFBs and RZEDBs must be issued on or before December 31, 2010.

- The ARRA does not provide for allocation of RZFBs or RZEDBs to cities that are not Large Municipalities.
- The ARRA provides that Counties and Large Municipalities may waive any portion of their allocations (volume cap). The States are authorized to reallocate the waived allocations (volume cap) "in any reasonable manner as it shall determine in good faith in its discretion."

- The Georgia Department of Community Affairs ("DCA") and the Georgia State Financing and Investment Commission are responsible for the reallocation of RZFBs and RZEDBs among Georgia's Counties and Large Municipalities and managing the RZ Bond program. John Gornall is serving as a member of DCA's advisory committee for RZ Bonds.

Given the wide scope of private activity projects which can be financed with RZFBs and the currently available fixed rates of around 4%, we expect a rush of developers to lobby Counties and Large Municipalities for some portion of their allocation.

Investing in Georgia renewable energy is more economically and financially attractive than ever before after the passage of ARRA. Combinations of the federal and Georgia tax incentives, grants and federally assisted financing alternatives described above can be utilized to substantially reduce the capital and financing costs of renewable energy investments and projects. Some of these tools will disappear after December 31, 2010. There is definitely a need for speed if Georgia is to capitalize on this opportunity to use federal tax and financing incentives to grow Georgia's renewable energy industries and services.

The rules governing the federal tax incentives remain very technical in several areas. The Internal Revenue Service is providing some guidance in installments. For additional information and assistance regarding the federal renewable energy tax credits, please contact Mark Gould, Jim Rauschenberger or John Brown or any of the other attorneys in Arnall Golden Gregory's Energy or Tax Practice Groups.

Similarly, details of and guidance about the Georgia tax credits and grant programs as well as the Recovery Zone Bond program are being provided in installments. Recently, GEFA posted guidance about its energy grant programs on its website www.gefa.org. For additional information and assistance with Georgia's tax credit and grant programs as well as the Recovery Zone Bond program, contact John Gornall, Andrew Schutt or any of the attorneys in Arnall, Golden Gregory's Economic Development or Energy Practice Groups.