

ENERGY TAX INCENTIVES ACT OF 2005 AND THE SAFE, ACCOUNTABLE, FLEXIBLE, EFFICIENT TRANSPORTATION EQUITY ACT: A LEGACY FOR USERS

Michael E. Mares, CPA/ABV, J.D.

I. OVERVIEW

- A. The Energy Policy Act of 2005 and the SAFE Transportation Equity Act of 2005 both included tax provisions.
- B. The Energy Act was signed into law on 8-8-05 and the Highway Act was signed into law on 8-10-05.
- C. Both acts took years to get through. The Energy Act has been languishing for about four years while the Highway Act was extended multiple times by Congress until its final passage.

II. INDIVIDUAL PROVISIONS

- A. Residential energy property credit calculations
 - 1. A credit of up to \$500 can be claimed for nonbusiness energy property installed at a taxpayer's principal residence. If less than 80% of the residence is used for nonbusiness purposes, then only a pro-rata share of the costs are eligible for the credit.
 - 2. Nonbusiness energy property includes such items as
 - a. Residential exterior doors and windows
 - b. Insulation
 - c. Heat pumps
 - d. Furnaces
 - e. Central air conditioners
 - f. Water heaters

3. Nonbusiness energy improvements include
 - a. Insulation materials
 - b. Exterior windows, including skylights
 - c. Exterior doors
 - d. Metal roofs with special pigmented coatings
 - e. Electric heat pump water heaters
 - f. Electric and geothermal heat pumps
 - g. Central air conditioners
 - h. Natural gas, propane, or oil water heaters or furnaces
 - i. Hot water boiler
 - j. Advanced main air circulating fans
4. The credit equals the cost of the residential energy property plus 10% of the cost of qualified energy efficiency improvements, limited to a lifetime credit of \$500. In addition, there are other, specific limits
 - a. Window components - \$200
 - b. Advanced main circulating air fan - \$50
 - c. Qualified natural gas, propane or oil furnace or hot water boiler – \$150
 - d. Any item of energy-efficient building property - \$300
5. A qualified energy efficiency improvement is an energy efficient building envelope component that meets the criteria set forth in the 2000 International Energy Conservation Code (IECC), in effect on the date of enactment of the Energy Act, or a metal roof that meets the Energy Star Program requirements.
6. Building envelope components are
 - a. Any insulation material or system specifically designed to reduce the heat loss or gain of a dwelling unit when installed in or on the dwelling unit
 - b. Exterior windows (including skylights)
 - c. Exterior doors



- d. Any metal roof but only if it has appropriate pigmented coatings specifically and primarily designed to reduce the heat gain of the dwelling unit
 - e. The 2000 IECC prescribes R-values for insulation at various locations in the building and U-factors for window and door glass, as well as the percentage of gross exterior wall area for these components depending on the type of building and the climate zone.
 - f. In addition, the 2000 IECC provides specifications for heating and cooling systems, including duct systems and related insulation, temperature and humidity controls, and water heating systems.
 - g. The Energy Star program requirements control in the case of metal roofs coated with heat-reduction pigment
7. The building envelope component must be installed on or in connection with the taxpayer's principal residence within the United States, originally placed into service by the taxpayer, and the component must be reasonably expected to remain in use for at least five years.
 8. The building envelope is defined by the U.S. Department of Energy to include "everything that separates the interior of a building from the outdoor environment, including the windows, walls, foundation, basement slab, ceiling, roof system and insulation.
 9. It appears that labor costs associated with the installation of qualified property don't qualify for the credit.
 10. The credit can be split among co-owners of a principal residence, but the total credit cannot exceed \$500.
 11. The credit is a nonrefundable personal credit. Thus, it can't reduce AMT.
 12. These provisions are effective for improvements placed in service in 2006 and 2007.
- B. Solar and Fuel Cell Credit
1. An annual credit of 30% of the cost of eligible solar water heaters, and solar electricity equipment, up to \$2,000 is available for installations of each category of property made on a personal residence.
 2. In addition 30 percent of the cost of any fuel cell equipment, up to a maximum of \$500 for each .5 kilowatt of capacity purchased by the homeowner per year is allowed. There is no annual limitation on this credit.
 3. Subsidies excludable from taxable income can't be taken into account in computing the credit.



4. Déjà vu – Remember the old residential energy credit from the mid-80s? Well those regulations may be dusted off and reprinted, since some of the elements of this law are very similar to those contained in the old residential energy credit provisions.
5. The credit is nonrefundable and can't be used to offset AMT.
6. A "residence" of the taxpayer qualifies for the solar and solar electric credit, but only the principal residence qualifies for the fuel cell credit.
7. Unused credits may be carried forward for one year.
8. Solar panels that are used for water heating and photovoltaic systems are eligible for the credit even if they constitute a structural component of the building on which they are installed
9. The credit does not apply to expenditures that are allocable to a swimming pool, hot tub, or other activity that has a function other than energy storage.
10. Fuel cell property is eligible for the residential alternative energy credit if it is a fuel cell power plant that generates at least .5 kilowatt of electricity using an electrochemical process and has an electricity-only generation efficiency of greater than 30 percent.
11. If less than 80% of the residence is used for nonbusiness purposes, then only a pro-rata share of the costs are eligible for the credit.
12. The credit is available for property placed in service in 2006 and 2007.

III. BUSINESS PROVISIONS

- A. Energy Efficient Commercial Buildings
 1. Taxpayers can claim a deduction of up to \$1.80 a square foot for the cost of energy-efficient commercial building property placed in service.
 2. The \$1.80 limit is cumulative and must be reduced by deductions taken for the particular building in prior years.
 3. The basis of the property generating the deduction must be reduced by the amount of the deduction.
 4. For public property, the IRS is required to issue regulations permitting an allocation of the deduction to the person responsible for designing the property. This will permit the transfer of the deduction to the designers of the property, thereby encouraging energy efficient designs in municipal buildings.
 5. Criteria for qualifying costs



- a. The costs must be associated with depreciable or amortizable property installed within a commercial building that is within the scope of Standard 90.1-2001.
 - b. The property must be installed pursuant to a plan to reduce the annual energy costs of the building (interior lighting, heating, cooling, ventilation and hot water) by at least 50% when compared to a building meeting the minimum requirements of Standard 90.1-2001.
 - c. The plan must be certified by the IRS, which is required to consult with the Secretary of Energy on the matter using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual.
 - d. To get the full deduction, all of the systems noted in e below must be impacted. The goal is overall energy usage reduction, not a reduction in a specific area.
 - e. The property must be installed as part of
 - i. interior lighting system
 - ii. heating, cooling, ventilation and hot water systems
 - iii. building envelope – See II A 8 above. While not defined for purposes of this section, the term is defined for the residential energy-efficient property, and it would seem logical that the same definition would apply here.
6. Standard 90.1-2001 is a publication of the American Society of Heating, Refrigerating, and Air Conditioning Engineers (ASHRAE) and the Illuminating Engineering Society of North America (IESNA). The Standard provides minimum requirements for the design of energy efficient buildings other than low-rise residential buildings. It has general industry acceptance and has been incorporated in the International Energy Conservation Code (IECC) for 2003. Its language is often adopted into new building codes, and it also addresses modifications to existing buildings.
7. The cost calculation methods must be fuel-neutral, not favoring one energy source over another.
8. Certification of the energy plan is required. Although the IRS is charged with designing and overseeing this process, Congress created the following procedures
- a. The certification must include both design and testing by individuals recognized by an IRS approved organization.



- b. The tests should be designed to comply with the energy savings plans and targets.
 - c. The procedures used in testing must be comparable to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems, taking into account the differences between residential and commercial buildings.
9. The IRS is required to issue regulations providing for partial deductions (up to \$.60 per square foot) even if the overall energy savings goals are met. The regulations will add specific targets for each system listed above.
10. Congress issued interim rules for interior lighting systems to qualify for the \$.60 per square foot deduction. To qualify, a lighting system must reduce lighting power density (LPD) by 40 percent of the minimum requirements contained in Table 9.3.1.1 or Table 9.3.1.2 of Standard 90.1-2001.
11. If the reduction in LPD is 25 percent of the minimum requirements, a \$.25-per-square-foot deduction is allowed. If the reduction is below 25 percent of the minimum requirements (50 percent in the case of warehouses), the target has not been met and no deduction is allowed.
12. If the reduction of LPD is between 25 percent and 40 percent of the minimum requirements the deduction will be reduced by a percentage equal to the sum of 50 and the amount that bears the same ratio to 50 as the excess of the reduction over 25 percentage points bears to 15.
13. Lighting systems with controls or circuits not fully in compliance with Standard 90.1-2001 don't qualify for the deduction.
14. Likewise, systems that do not include bi-level switching don't qualify, except in hotel/motel guest rooms, store rooms, restrooms and public lobbies.
15. Systems failing to meet the minimum requirements for calculated lighting levels contained in the Illuminating Engineering Society of North America (IESNA) Lighting Handbook, Performance and Application, Ninth Edition, 2000, don't qualify.
16. These provisions apply to property placed in service after 12-31-05 and before 1-1-08.
- B. Homebuilder's Credit for New Energy-Efficient Homes**
- 1. Homebuilders can qualify for a \$1,000 or \$2,000 credit for new homes acquired as a residence during 2006 and 2007.
 - 2. To qualify, the homebuilder must build a new energy-efficient home or manufacture a new energy-efficient manufactured home.



3. To be a qualified new energy-efficient home the following requirements must be met:
 - a. The home must be located in the United States
 - b. Its construction (the term includes substantial reconstruction and rehabilitation) must be substantially completed after August 8, 2005 and
 - c. It must meet the following energy saving requirements to qualify for the \$2,000 credit
 - i. the home must be certified to have a level of annual heating and cooling energy consumption at least 50 percent below the annual heating and cooling energy consumption of a comparable dwelling unit and
 - ii. the home must be certified to have building envelope component improvements that account for at least one-fifth of that 50 percent improvement in heating and cooling energy.
 - d. A comparable dwelling unit is one that is constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code (including supplements) in effect on 8-8-05, with heating and cooling equipment efficiencies that correspond to the minimum allowed under regulations established by the Department of Energy under the National Appliance Energy Conservation Act of 1987 in effect at the time construction was completed.
 - e. A manufactured home can also qualify for the \$2,000 credit if it meets these same tests and conforms to the Federal Manufactured Home Construction and Safety Standards set forth at Title 24 CFR Sec. 3280
 - f. A manufactured home that does not meet these tests can nevertheless qualify for a \$1,000 credit if it conforms to the Federal Manufactured Home Construction and Safety Standards, and
 - i. it is certified to have a level of annual heating and cooling energy consumption at least 30 percent below the annual heating and cooling energy consumption of a comparable dwelling unit
 - ii. to have building envelope component improvements that account for at least one-third of that 30-percent improvement or
 - iii. it meets the requirements established by the Environmental Protection Agency under the Energy Star Labeled Homes.
4. Certification of a qualified new energy-efficient home will be made in accordance with guidance provided by the Treasury, after consultation with the Dept. of Energy.



5. The certification must be written and specify in a readily verifiable manner the energy-efficient building envelope components and heating or cooling equipment in the home and the respective rated energy efficiency.
6. This credit is part of the general business credit, so it has limited use against the AMT, but unused credits can be carried over.
7. If any expenditure qualifies for the credit that would otherwise increase basis, the basis increase must be reduced by the amount of the credit.
8. This provision applies to qualified energy-efficient homes acquired after 12-31-05, but before 1-1-08.

C. New Credit for Manufacturing Energy Efficient Appliances

1. Manufacturers of dishwashers, clothes washers and refrigerators now qualify for a new credit.
2. The total amount of credit available for any year equals the total of the credit amount separately calculated for each type of qualified energy-efficient appliance produced by the taxpayer during the calendar year ending with or within that tax year.
3. The credit amount for each type of qualified appliance is determined by multiplying the eligible production for that type of appliance by the appliance's applicable amount.
4. The maximum amount of this credit is limited to the lesser of \$75 million per tax year for all qualifying appliances manufactured during that year or 2% of the taxpayer's average gross receipts for the prior three years.
5. In each subsequent year the cap is reduced by the amount (if any) of the credit used in any prior tax year.
6. Of the \$75 million cap (or the reduced cap, if applicable), no more than \$20 million of credit amount in a single tax year can result from the manufacture of refrigerators to which the \$75 million applicable amount applies (i.e., refrigerators which are at least 15 percent but no more than 20 percent below 2001 energy conservation standards).
7. For purposes of computing gross receipts, the aggregation rules under IRC Sec. 448 for determining a taxpayer's eligibility to use the cash method of accounting apply in determining the taxpayer's gross receipts.
 - a. All persons will be treated as a single employer under the controlled group rules.
 - b. Gross receipts will be adjusted for entities that were not in existence for the full three-year period or that had tax years of less than 12 months.



- c. Gross receipts will be decreased by returns and allowances for the taxpayer's predecessors within the three-year base.
 - d. All persons treated as a single employer under the controlled group rules are treated as a single manufacturer for purposes of the credit.
 - e. The fact that a foreign corporation may be a member of a consolidated group that produces energy-efficient appliances will not preclude claiming the credit on the consolidated return, and the consolidated group will be considered as a single manufacturer for this purpose.
8. Specific requirements for appliances
- a. Dishwashers - a residential dishwasher that is subject to the Department of Energy conservation standards
 - i. the dishwasher must be manufactured during 2006 or 2007 and must meet the requirements of the Energy Star program as in effect for dishwashers in 2007.
 - ii. the applicable amount for qualified dishwashers is the energy savings amount, which is equal to the lesser of \$100 or the product of \$3 and 100 multiplied by the energy savings percentage.
 - iii. the energy savings percentage is the ratio of:
 - (1) the energy factor (EF) established by the Department of Energy for compliance with the Federal energy conservation standards (the Energy Star program) for dishwashers in 2007, minus the EF required by the Energy Star program for dishwashers in 2005; to
 - (2) the EF required by the Energy Star program for dishwashers in 2007.
 - b. Clothes Washer – a residential clothes washer, including residential style coin-operated washers.
 - i. the clothes washer must be manufactured during 2006 or 2007 and must meet the requirements of the Energy Star Program as in effect for clothes washers in 2007.
 - ii. the amount for determining the credit is \$100.
 - c. Refrigerator
 - i. must have an interior volume of at least 16.5 cubic feet
 - ii. must be equipped with an automatic defrost for both the refrigerator and freezer



iii. amounts qualifying for the credit

- (1) if it is manufactured during 2006 and it consumes at least 15%, but not more than 20% less kilowatt-hours per year than the conservation standards for refrigerators promulgated by the Department of Energy that took effect on July 1, 2001, then the applicable amount is \$75.
- (2) if it is manufactured during calendar years 2006 or 2007 and consumes at least 20 percent, but not more than 25 percent, less kilowatt-hour per year than the 2001 energy conservation standards, then the applicable amount is \$125.
- (3) if it is manufactured during calendar year 2006 or 2007 and consumes at least 25 percent less kilowatt-hours per year than the 2001 energy conservation standards, then the applicable amount is \$175.

- d. The eligible production amount for an energy efficient appliance is determined by subtracting the average number of qualified appliances produced during the preceding three-calendar-year period from the number of appliances of the same type that the taxpayer produced during the applicable calendar year. Only qualified appliances produced in the United States apply.
- e. A special rule applies to calculating eligible production for refrigerators. For this type of appliance, eligible production is determined by subtracting 110 percent of the average number of qualified refrigerators that were produced during the preceding three-calendar-year period from the number of qualified refrigerators that the taxpayer produced during the applicable calendar year. As with the other appliances only qualified refrigerators produced in the United States qualify.

9. This credit is part of the general business credit.

D. Business Solar Investment Tax Credit

1. The credit for solar energy property is increased from 10% to 30%
2. Qualifying property – Equipment using solar energy to
 - a. Generate electricity
 - b. Heat or cool (or provide hot water for use in) a structure
 - c. Provide solar process heat
 - d. Illuminate the inside of a structure using fiber-optic distributed sunlight, effective for periods ending before January 1, 2008.



3. The credit is part of the general business credit.
4. This credit is effective for years ending after 12-31-05.

E. Energy Research Credit

1. The research credit is modified for qualified energy research.
2. The qualified energy research credit is 20% of all amounts paid or incurred (no base amount required) to an energy research consortium.
3. An energy research consortium is a 501(c)(3) tax exempt organization which is not a private foundation and to which
 - a. To which at least five unrelated persons paid or incurred amounts to such organization during the calendar year for energy research and
 - b. To which no single person paid or incurred during the calendar year more than 50 percent of the total amounts received by the organization for energy research during the year
4. Amounts paid to eligible small businesses, a university or a federal lab for qualified energy research is contract research. In that case, the 65% limitation is replaced with a 100% limitation.
5. An eligible small business is a small business in which the taxpayer does not own a 50 percent or greater interest in the business, and the business has employed, on average, 500 or fewer employees during either of the two preceding calendar years.
6. If the small business is a corporation, the 50 percent ownership test is determined with reference to the taxpayer's ownership of the business' outstanding corporate stock (determined by vote, or by value).
7. If the small business is not a corporation, the taxpayer's ownership in the business is determined with reference to the taxpayer's percentage of ownership in the capital and profits interests of the small business.
8. If there is a startup, controlled group or a predecessor, rules similar to those of IRC Sec. 220(c)(4)(B) and (D) apply (the Archer MSA rules)
9. Expenditures qualifying for the increased rate are those that would qualify for the research credit under current law, relating to the production, supply and conservation of energy, including otherwise qualifying research expenditures related to alternative energy sources or the use of alternative energy sources.
10. This provision is effective for amounts paid or incurred after 10-8-05, in years ending after that date.



F. Qualified Fuel Cell Property and Stationary Microturbine Power Plants

1. The business energy credit now includes fuel cell property and stationary microturbine property.
2. The credit is 30% of the basis of fuel cell property placed in service during the year, not to exceed \$500 for each .5 kilowatt of capacity of such property.
3. The credit for stationary microturbine power plants is 10 percent of the basis of such property placed in service during the tax year, not to exceed \$200 for each kilowatt of capacity of the plant.
4. Qualified fuel cell property is a fuel cell power plant that generates at least 0.5 kilowatt of electricity using an electrochemical process and has electricity-only generation efficiency greater than 30 percent.
5. A 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 that converts a fuel into electricity and thermal energy. It 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.
6. This credit applies to qualified fuel cell property and to qualified microturbine property used predominately in the trade or business of furnishing or selling telephone services, domestic telegraph services or other telegraph services, other than international telegraph services.
7. This provision is effective for tax periods ending after 12-31-05, but not for any period ending after 12-31-07.

G. Recapture of Amortization

1. If multiple intangibles are disposed of, including by sale, the seller must calculate recapture as if all of the intangibles were a single asset. Thus, any gain on the sale or other disposition of the intangibles is recaptured as ordinary income.
2. The recapture rules don't apply to amortizable intangibles if the adjusted basis exceeds FMV.
3. This provision applies to property dispositions after 8-8-05.



IV. MOTOR VEHICLE PROVISIONS

A. New Qualified Fuel Cell Motor Vehicle Credit

1. A new credit is available for a qualifying fuel cell motor vehicle, pursuant to the following table

<u>Gross Vehicle Weight</u>	<u>Credit</u>
Not more than 8,500 lbs (if placed in service after December 31, 2009)	8,000 4,000
More than 8,500 lbs but not more than 14,000 lbs	10,000
More than 14,000 lbs but not more than 26,000 lbs	20,000
More than 26,000 lbs	40,000

2. To qualify, the motor vehicle must meet the following requirements
 - a. The original use of the vehicle must begin with the taxpayer
 - b. The vehicle must be acquired for the use or lease of the taxpayer and not for resale
 - c. The vehicle must be made by a manufacturer
 - d. If the vehicle is a passenger auto or light truck, the vehicle must be certified as meeting or exceeding the Bin 5, Tier II emission standard established in the regulations under the Clean Air Act for that make and model year
 - e. For states, such as California, that have passed equivalent qualifying emission standards, the vehicle is required to also be certified for those standards for that particular make and model year
 - f. In addition, the vehicle must be propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel.
 - g. Fuel cell vehicles that meet the definition of either a passenger automobile or "light truck (see and meet certain standards for increased fuel efficiency will be able to increase their credit amount based on the increase in fuel efficiency over the 2002 city fuel economy standards, determined by the following table:



<u>% of 2002 Additional Fuel Economy</u>	<u>Credit</u>
At least 150 percent but less than 175 percent	1,000
At least 175 percent but less than 200 percent	1,500
At least 200 percent but less than 225 percent	2,000
At least 225 percent but less than 250 percent	2,500
At least 250 percent but less than 275 percent	3,000
At least 275 percent but less than 300 percent	3,500
At least 300 percent	4,000

3. This provision is effective for vehicles placed in service after 12-31-005 for tax years ending after that date. The provision will not apply to vehicles purchased after 12-31-14.

B. New Advanced Lean Burn Technology Motor Vehicle Credit

I. Requirements for claiming credit

- a. The original use of the vehicle must begin with the taxpayer
 - b. The vehicle must be acquired for the use or lease of the taxpayer and not for resale.
 - c. The vehicle must be made by a manufacturer
 - d. The vehicle must be a passenger auto or light truck with an internal combustion engine that is designed to operate primarily using more air than necessary for the complete combustion of the fuel, incorporates direct injection and achieves at least 125% of the 2002 model year city fuel economy
2. 2004 model year vehicles must also receive a certificate that the vehicle meets or exceeds the Bin 5, Tier II emission standard established under the Clean Air Act for that make and model year, if the gross vehicle weight rating is 6,000 pounds or less.
 3. 2004 model year vehicles with a gross vehicle weight rating of more than 6,000 pounds but not more than 8,500 pounds must be certified to meet or exceed the Bin 8, Tier II emission standard established under the Clean Air Act.
 4. The credit equals the following amounts

At least 125 percent but less than 150 percent	400
At least 150 percent but less than 175 percent	800
At least 175 percent but less than 200 percent	1,200
At least 200 percent but less than 225 percent	1,600
At least 225 percent but less than 250 percent	2,000
At least 250 percent	2,400



5. The credit can be increased by a conservation credit based on lifetime fuel savings in gallons of gas

At least 1,200 but less than 1,800	250
At least 1,800 but less than 2,400	500
At least 2,400 but less than 3,000	750
At least 3,000	1,000
6. Lifetime fuel savings is the excess of 120,000 divided by the 2002 model year city fuel economy for the vehicle inertia weight class over 120,000 divided by the city fuel economy for the vehicle.
7. The credit for the new advanced lean burn technology motor vehicle credit and the new qualified hybrid motor vehicle credit is limited by the sum total of the number of units sold by the manufacturer.
8. The credit amounts will be phased out when a manufacturer of these vehicles certifies that it has sold a combined total of 60,000 of these vehicles for use in the United States after December 31, 2005.
9. For these purposes, controlled groups of corporations are considered to be a single entity and related foreign corporations are included in the single entity.
10. For vehicles purchased in the calendar quarter that includes the date of the sale of the 60,000th unit, and the next calendar quarter, taxpayers will be allowed to continue to claim the full allowable credit amount.
11. The credit amount will be limited to 50% of the allowable credit amount for vehicles purchased in the next two calendar quarters and to 25% of the allowable credit amount for vehicles purchased in the next two calendar quarters.
12. The credit will be disallowed for all calendar quarters thereafter
13. This provision is effective for vehicles placed in service after 12-31-05 and terminates as of 12-31-10. Vehicles purchased after 12-31-10 won't qualify for the credit.

C. New Qualified Hybrid Motor Vehicle Credit

- I. Requirements for claiming credit
 - a. The original use of the vehicle must begin with the taxpayer
 - b. The vehicle must be acquired for the use or lease of the taxpayer and not for resale.
 - c. The vehicle must be made by a manufacturer



- d. The vehicle must draw propulsion energy from onboard sources of stored energy that are both an internal combustion or heat engine using consumable fuel, and a rechargeable energy storage system.
 - e. Passenger automobiles or light trucks must receive a certificate of conformity under the Clean Air Act, and meet or exceed the equivalent qualifying California low emission vehicle standard under Sec. 243(e)(2) of the Clean Air Act for that make and model year.
 - f. If the vehicle has a gross weight rating of 6,000 pounds or less, it must meet or exceed the Bin 5, Tier II emission standard established in the regulations under the Clean Air Act for that make and model year.
 - g. Vehicles with a gross weight rating of more than 6,000 pounds but not more than 8,500 pounds must meet or exceed the Bin 8, Tier II emission standard.
 - h. The vehicle must have a maximum available power of at least
 - i. 4 percent, in the case of a passenger automobile or light truck with a gross vehicle weight rating of not more than 8,500 pounds
 - ii. 10 percent, in the case of a vehicle which has a gross vehicle weight rating of more than 8,500 pounds but not more than 14,000 pounds
 - iii. 15 percent, in the case of a vehicle which has a gross vehicle weight rating in excess of 14,000 pounds
2. 2004 through 2007 model years, other than passenger automobiles or light trucks with a gross weight rating of no more than 8,500 pounds with an internal combustion or heat engine, must receive a certificate of conformity under the Clean Air Act as meeting the emission standard established in the regulations for either a diesel heavy duty engine or an ottocycle heavy duty engine.
 3. A qualified hybrid motor vehicle doesn't include a non-passenger car or light truck if the vehicle has a gross vehicle weight rating of less than 8,500 pounds – translation – no SUVs.
 4. Consumable fuel means any solid, liquid, or gaseous matter releasing energy when consumed by an auxiliary power unit
 5. Maximum available power means
 - a. In the case of passenger automobiles or light trucks that have a gross vehicle weight rating of not more than 8,500 pounds, the maximum power available from the rechargeable energy storage system, during a standard 10-second pulse power or equivalent test, divided by such maximum power and the Society of Automotive Engineers (SAE) net power of the heat engine



- b. In the case of all other vehicles, the maximum power available from the rechargeable energy storage system during the standard 10-second pulse power or equivalent test, divided by the vehicle's total traction power.
 - c. Total traction power means the sum of the peak power from the rechargeable energy storage system and the heat engine peak power of the vehicle.
 - d. If the sole means by which the vehicle can be driven is by the rechargeable energy storage system, then the "total traction power" is the peak power of such storage system
6. The credit amounts are the same as those for the Lean Burn Technology Credit for passenger cars and light trucks with a gross vehicle weight rating less than 8,500 pounds. See B 4 and 5 above.
 7. If the qualified hybrid motor vehicle is not a passenger automobile or light truck with a gross vehicle weight rating under 8,500 pounds, the credit amount is equal to an applicable percentage times the qualified incremental hybrid cost of the vehicle as certified by the manufacturer in accordance with guidance to be issued by the IRS. The guidance will specify the procedures and methods for calculating the fuel economy savings and the incremental hybrid costs.
 8. The applicable percentages are
 - a. 20 percent, if the vehicle achieves an increase in city fuel economy relative to a comparable vehicle of at least 30 percent but less than 40 percent
 - b. 30 percent, if the vehicle achieves an increase in city fuel economy relative to a comparable vehicle of at least 40 percent but less than 50 percent
 - c. 40 percent, if the vehicle achieves an increase in city fuel economy relative to a comparable vehicle of at least 50 percent. The qualified incremental hybrid cost is equal to the amount of the excess of the manufacturer's suggested retail price (MSRP) for the hybrid vehicle over the MSRP of a comparable vehicle.
 9. The incremental hybrid cost cannot exceed
 - a. \$7,500, if the hybrid vehicle has a gross vehicle weight rating of not more than 14,000 pounds
 - b. \$15,000, if the hybrid vehicle has a gross vehicle weight rating of more than 14,000 pounds but not more than 26,000 pounds
 - c. \$30,000, if the hybrid vehicle has a gross vehicle weight rating of more than 26,000



10. A comparable vehicle is any vehicle that is powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size and use to the hybrid vehicle in question.
11. The qualified hybrid credit is also subject to the maximum unit limitations of the lean burning vehicle credit. See B 8 – 12 above.
12. This provision is effective for vehicles placed in service after 12-31-05 and purchased before 1-1-10.

D. Qualified Alternative Fuel Vehicle Credit

1. Requirements for claiming credit

- a. The original use of the vehicle must begin with the taxpayer
- b. The vehicle must be acquired for the use or lease of the taxpayer and not for resale.
- c. The vehicle must be made by a manufacturer
- d. The vehicle must be capable of using an alternative fuel, defined as compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85 percent of the volume of which consists of methanol

2. The amount of credit equals the applicable percentage times the incremental cost of the vehicle

- a. 50% plus 30%, if the vehicle has received a certificate of conformity under the Clean Air Act and meets or exceeds the most stringent standard available for certification under the Clean Air Act for that make and model year vehicle (other than a zero emission standard) or has received an order certifying the vehicle as meeting the same requirements as vehicle which may be sold or leased in California and meets or exceeds the most stringent standard available for certification under the state laws of California for that make or model year vehicle (other than a zero emission standard).

- b. For a qualified alternative fuel motor vehicle with a gross vehicle weight rating of more than 14,000 pounds, the most stringent standard available shall be such standard available for certification on August 8, 2005.

3. Incremental cost equals the excess of the manufacturer's suggested retail price (MSRP) for the vehicle over the MSRP for a gasoline or diesel fuel motor vehicle of the same model, to the extent that amount does not exceed

- a. \$5,000, if the vehicle has a gross vehicle weight rating of not more than 8,500 pounds



- b. \$10,000, if the vehicle has a gross vehicle weight rating of more than 8,500 pounds but not more than 14,000 pounds
 - c. \$25,000, if the vehicle has a gross vehicle weight rating of more than 14,000 pounds but not more than 26,000 pounds
 - d. \$40,000, if the vehicle has a gross vehicle weight rating of more than 26,000 pounds
 - 4. The new qualified alternative fuels motor vehicle credit may be claimed in a reduced amount for vehicles that use a mixture of alternative fuel and petroleum-based fuels.
 - 5. The credit for mixed-fuel vehicles is expressed as a percentage of the new qualified alternative fuel motor vehicle credit. If a mixed fuel vehicle uses a 75/25-percent mixture (at least 75-percent alternative fuel and at most 25-percent petroleum based fuel), it is eligible for 70 percent of the credit. If it uses a 90/10-percent mixture (at least 90-percent alternative fuel and at most 10-percent petroleum-based fuel), it is eligible for 90 percent of the qualified alternative fuels motor vehicle credit,
 - 6. A qualifying mixed-fuel vehicle is
 - a. A vehicle whose gross vehicle weight rating is more than 14,000 pounds
 - b. A vehicle that is certified by the manufacturer as being able to perform efficiently in normal operation on a combination of an alternative fuel and a petroleum-based fuel
 - c. A vehicle that either
 - i. has received a certificate of conformity under the Clean Air Act, or
 - ii. has received an order certifying the vehicle as meeting the same requirements as vehicles which may be sold or leased in California and meets or exceeds the low emission vehicle standard for that make and model year vehicle, and
 - iii. a vehicle that meets the three requirements common to all the credit components of the alternative motor vehicle credit. See A 2 a,b and c above.
 - 7. This provision is effective for vehicles placed in service after 12-31-05 and purchased before 1-1-11.
- E. Termination of Deduction for Clean-Fuel Vehicles
 - I. The deduction for clean-fuel vehicles is being phased-out one year early.



2. No deduction will be permitted for vehicles placed in service after 12-31-05.
3. With the addition of the alternative motor vehicle credits, this deduction was no longer necessary.

F. Gas Guzzler Tax for Limousines

1. The gas guzzler tax for limousines greater than 6,000 pounds unloaded gross vehicle weight is repealed after 9-30-05.
2. The definition of automobile no longer includes the term “limousine” for purposes of the gas-guzzler tax.

G. Exclusion From Excise Tax

1. Highway tractors are now exempt from the excise tax on highway tractors that meet certain weight restrictions.
2. Weight restrictions
 - a. The tractor must have a gross weight not exceeding 19,500 pounds and
 - b. When combined with the trailer or semi trailer, must have a combined weight of no more than 33,000 pounds.
3. The provision applies to sales after 9-30-05.

H. Tire Excise Tax Modifications

1. Super single tires don't include any tire designed for steering.
2. Steering tires are taxable if they are used on highway vehicles, are wholly or partly made of rubber and marked for highway use under federal regulations.
3. This provision applies to sales in calendar years beginning on or after 1-1-05.

V. NATURAL RESOURCES

A. Depreciation of Natural Gas Gathering Pipelines

1. Natural gas gathering lines placed in service after 4-11-05 are MACRS 7 year property for both producers and nonproducers.
2. The alternative MACRS life for this property is 14 years.
3. The original use of the property must commence with the taxpayer after 4-11-05.



4. Property placed in service by the taxpayer or a related party after 4-11-05 but subject to a binding contract on or before 4-11-05 also doesn't qualify. For self-constructed property, construction must begin after 4-11-05.
5. A natural gas gathering line is
 - a. Pipe, equipment, and appurtenances determined to be a gathering line by the Federal Energy Regulatory Commission
 - b. Pipe, equipment, and appurtenances used to deliver natural gas from the wellhead or a common point to the point at which the gas first reaches either
 - i. a gas processing plant
 - ii. an interconnection with a transmission pipeline for which a certificate as an interstate transmission pipeline has been issued by the Federal Energy Regulatory Commission
 - iii. an interconnection with an intrastate transmission pipeline
 - iv. a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer
6. No depreciation adjustment is required for AMT purposes for depreciation claimed on a natural gas gathering pipeline not treated as 7-year property.
7. This provision applies to property placed in service after 4-11-05, subject to the binding contract exception discussed in 4 above.

B. Two Year Amortization for Geological and Geophysical Costs

1. Geological and geophysical expenses incurred or paid in connection with oil and gas exploration or development in the US must be amortized over a 24-month period beginning on the mid-point of the tax year in which the expenses were paid or incurred.
2. There are no other options for claiming a deduction for these expenses. Thus, the capitalization of these costs is no longer permitted.
3. If the property is retired or abandoned before the end of the 24-month period, no additional deduction for the retirement or abandonment in that year is permitted.
4. For purposes of this deduction, the US includes the seabed and subsoil of submarine areas adjacent to the territorial waters of the US, over which the US has exclusive exploration and exploitation rights under international law.



5. Amounts subject to amortization under this provision aren't subject to capitalization under IRC Sec. 263A.
 6. This provision applies to amounts paid or incurred in tax years beginning after 8-8-05.
- C. Safe Harbor From Tax-Exempt Bond Arbitrage Rules For Prepaid Natural Gas
1. A safe harbor from the arbitrage rules is provided for qualifying prepaid natural gas supply contracts purchased by certain state and local government utilities.
 2. Qualified prepayments under the contracts don't result in the acquisition of investment-type property.
 3. A qualified natural gas supply contract is one that does not exceed the sum of
 - a. The annual average amount of natural gas purchased (other than for resale) during the testing period by customers of the utility located within its service area plus
 - b. The amount of natural gas used to transport the prepaid natural gas to the utility during the year.
 - c. In computing the annual average natural gas that is used to generate electricity can be taken into account only if the electricity is generated by a government-owned utility and only to the extent that electricity is sold (other than for resale) to customers of the utility located within its service area.
 - d. The testing period is the most recent five calendar years ending prior to the date of the bond issue.
 - e. The service area is any area through which the utility provided natural gas transmission or distribution services or electric distribution services, including an area within a county contiguous to the service area if retail customers of the utility are not served by another natural gas or electric service utility. A utility's service area also includes any area recognized as such by state or federal law.
 4. While adjustments are allowed to reflect new customers after the testing period ends, but before the bond issue takes place, the average can't exceed the annual amount of natural gas reasonably expected to be purchased for a reason other than resale by persons located within the utility's service area and who are its customers as of the date of the bond issue.
 5. Governmental entities have the opportunity to request a ruling to argue for a higher average based on growth in population or consumption.



6. An "applicable share" of natural gas on hand when the bond issuance takes place must be subtracted from the amount of natural gas otherwise permitted to be acquired.
 7. The term "applicable share" means that the amount of natural gas must be allocated ratably over the period to which the prepayment applies.
 8. That reduction must include natural gas that the utility has the right to acquire during the period.
 9. Intentional acts on the part of a governmental entity to artificially inflate the volume of natural gas acquired by prepayment to exceed the sum of the amount of gas needed for purposes other than resale by its customers who are located within its service area, plus that amount of gas used to transport such natural gas to the utility, will result in loss of safe-harbor treatment.
 10. A conforming amendment provides an exception to the private activity bond rules for qualified electric and natural gas supply contracts covered by the safe-harbor rule. Such contracts will not be considered nongovernmental output property for purposes of the private activity rules.
 11. Private loan financing test is not applicable to a qualified natural gas supply contract.
 12. This provision applies to obligations issued after 8-8-05.
- D. Deduction for Capital Costs Incurred in Complying with EPA Sulfur Regulations
1. A small business refiner cooperative can allocate all or a portion of the deduction permitted for costs paid or incurred to comply with EPA sulfur regulations pro-rata among other cooperatives that directly hold an ownership interest in the refiner.
 2. To the extent the deductions are passed through to the patrons, the coop can't deduct those costs.
 3. An election to make the pass-through must be made on the coop's tax return for the year in question.
 4. A cooperative making the pass-through election must provide each coop owner written notice of the allocated amount by the due date for the tax return on which the election is made
 5. This provision is effective for expenses paid or incurred after 12-31-05 in tax years ending after that date.



E. Oil Spill Liability Trust Fund Financing Rate

1. The Oil Spill Liability Trust Fund financing rate ("oil spill tax") of five cents per barrel is reinstated on April 1, 2006, until the Oil Spill Fund reaches an unobligated balance of \$2.7 billion
2. After that, the oil spill tax will be reinstated 30 days after the last day of any calendar quarter for which the IRS estimates that, as of the close of that quarter, the unobligated balance of the Oil Spill Fund is less than \$2 billion.
3. The oil spill tax will cease to apply after December 31, 2014, regardless of the Oil Spill Fund balance.
4. This provision is effective on 8-8-05.

F. Credits For Investment in Clean Coal Facilities

1. Qualifying Advanced Coal Project Credit

- a. The taxpayer must have applied for and received a certification that the project satisfies the appropriate requirement
- b. The IRS must implement an advanced coal project within 180 days of 8-8-05.
- c. Up to \$1.3 billion in credits will be allocated to certified taxpayers.
- d. Up to \$800 million in credits can be allocated to integrated gasification combined cycle (IGCC) projects and up to \$500 million can be allocated to other projects using advanced coal based generation technologies.
- e. The amount of the credit is 20% of qualified investment in IGCC projects certified by the IRS and 15% of projects using other technologies.
- f. The qualified investment is the basis of property placed in service during the year.
- g. Qualified property is limited to that for which depreciation or amortization is allowed and for which the original use begins with the taxpayer.
- h. The basis of qualified property is reduced by the amount of any tax-exempt financing proceeds.

2. Qualifying Gasification Project Credit

- a. Taxpayers must file an application for certification



- b. The IRS is required to accept or reject the application within 60 days of submission.
 - c. Qualifications for certification include an IRS determination that
 - i. the project uses an advanced coal based generation technology to power a new electric generation unit or to refit or repower an existing electric generation unit
 - ii. the fuel input for the project, when complete, will be at least 75% coal
 - iii. the electric generation unit at the project will have a total nameplate generating capacity of at least 400 megawatts
 - iv. a majority of the output is reasonably expected to be acquired or utilized
 - v. the taxpayer provides evidence of ownership or control of a site sufficient to allow the proposed project to be constructed and operate on a long-term basis and
 - vi. the project will be located in the US.
 - d. The certification process also requires
 - i. the taxpayer has received all federal and state environmental clearances necessary to start construction
 - ii. the taxpayer, except in the case of a retrofit or repower of existing electric generation units has purchased or entered into a binding contract for the purchase of the main steam turbine. Contracts contingent on the certification will qualify.
- G. Credit for Producing Fuel from a Nonconventional Source Extended to Coke or Coke Gas Facilities
1. The nonconventional fuel source credit is extended to facilities producing coke or coke gas.
 2. The credit applies to coke or coke gas produced in facilities that were placed in service before 1-1-93 or after 6-30-98 and before 1-1-10 and sold during the period beginning on the later of 1-1-06 or the date the facility is placed in service and ending on the date that is four years after the project began.
 3. The amount of fuel qualifying for the credit can't exceed an average barrel-of-oil equivalent of 4,000 barrels per day with respect to the facility.



4. For fuels sold after 2005, the \$3 credit amount is adjusted for inflation using 2004 as the base year.
 5. This provision applies to fuel produced and sold after 12-31-05.
- H. Modification of Credit for Producing Fuel from a Nonconventional source
1. The nonconventional fuel credit is now included as part of the general business credit.
 2. As such, unused credits can be carried back one year and forward 20 years.
 3. The determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams or a tight formation is required to be made by the IRS in accordance with Section 503 of the Natural Gas Policy Act of 1978.
 4. This provision is effective for credits for tax years ending after 12-31-05. The provision pertaining to a determination under the Natural Gas Policy Act of 1978 is effective on 8-8-05.
- I. 84-Month Amortization of Air Pollution Control Facilities
1. The requirement that an air pollution control facility be used in connection with a plant that was in operation prior to 1-1-76 (if the plant is an electric generation plant or other property that is primarily coal fired) is repealed.
 2. The amortization period for a certified air pollution control facility qualifying because of this change is increased to 84 months from 60 months.
 3. This provision only applies if the taxpayer completes construction, reconstruction, or erection of the facility after 4-11-05 or if the facility is acquired after 4-11-05 and the original use of the facility commences with the taxpayer after that date.
 4. This provision applies to air pollution control facilities placed in service after 4-11-05.

Disclaimer: The information and opinions provided in this outline are for professional educational purposes only. Any use of these materials (i.e. to provide tax advice to clients) must be in accordance with applicable professional standards, including those included in Circular 230.

