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# It's Not Easy Being Green: Solar Tax Credits and Grants

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Energy independence is a major American policy goal, and the Internal Revenue Code has not been neglected in that push. There are tax credits for the manufacturing of "greentech" equipment and for purchases of energy-efficient appliances. Tax credits are available for business and homeowner purchases of properties that generate renewable energy. A tax credit can be claimed for each kilowatt-hour of electricity from various renewable energy sources. This article will focus on the business tax credit for purchases of solar panels and other solar energy property, an area of growing interest to commercial rental property owners. In lieu of the tax credit, property owners for a limited time can claim a grant equal to the amount of the credit, with fewer restrictions.

## Credits

The energy tax credit in Code section 48 is equal to 30 percent of the basis of purchased solar energy property used in the United States in a trade or business or income-producing activity. Solar energy property includes assets that use solar energy to generate electricity, or to heat or cool a structure, as well as solar water heaters and "equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight."

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The credit rate drops to 10 percent for solar energy property placed in service after January 1, 2017. The basis of the energy property is reduced by half of the amount of any credit claimed on the property.

The landlord of an office building may install solar panels on the building, claim the credit, and sell the electricity to the tenants. For example, if the landlord spends $200,000 on the solar panels, it can claim a tax credit of $60,000, which would reduce the basis in the solar panels by half the credit amount to $170,000. Since solar panels, like most energy property, are depreciated over a five-year period, the landlord can claim $34,000 of depreciation deductions in the first year (20 percent of the $170,000 basis).[1] If the property is disposed of during the five-year period, a gradually decreasing portion of the tax credit is recaptured and added to the landlord's tax liability. For example, $48,000 (80 percent of the tax credit) is recaptured if the landlord were to sell all the solar panels in year two. Furthermore, the basis reduction caused by the credit, as well as the cumulative depreciation, may be recaptured as ordinary income.

Many hurdles must be overcome in order to qualify for the tax credits. Individuals and certain other taxpayers are subject to the tax credit "at-risk" rules in Code section 49, which reduces the amount of the credit if the wrong sources of financing are used.

Even if the credits are not limited by the "at-risk" rules, other Code provisions may limit the landlord's ability to use the credits. For example, the landlord may be subject to the passive activity rules, since a rental business is almost always a passive activity. Losses and tax credits from passive activities cannot reduce the tax on active business income or portfolio income (such as interest and dividends). Rental real estate activity may become nonpassive only if the landlord materially participates in the activity and the landlord is a "real estate professional."

In addition, the $60,000 of nonrefundable solar tax credits are useful only if our hypothetical landlord has positive tax liability, though in some situations a lessor may elect to pass the credit to a lessee of the solar energy property. A 2008 change in the law now allows the energy tax credit to offset 100 percent of alternative minimum tax liability. A further limitation is that general business credits (such as the energy tax credit) cannot reduce a taxpayer's total tax liability below 25 percent of the taxpayer's regular income tax liability in excess of the first $25,000 (the "25-percent-of-tax limitation"). For example, if the landlord has $45,000 of regular tax liability, it may use only $40,000 of general business credits to reduce its taxes to $5,000 (25 percent of the excess of $45,000 over $25,000). The unused credits may be carried back one year and forward 20 years.

**Grants**

Taxpayers are effectively freed of many of the above rules thanks to the American Recovery and Reinvestment Act of 2009, which authorized "section 1603 grants" from the Treasury Department for energy property placed in service in 2009 or 2010 that is otherwise eligible for the energy tax credit. The grant is also available to energy property for which construction began in 2009 or 2010 if the property will ultimately be placed in service before January 1, 2017. The section 1603 grants and the energy tax credits are exactly equivalent in amount, and they cannot both be claimed for the same property. The grant for solar energy property is tax-free income equal to 30 percent of the property's basis, and the basis is then reduced by half the grant amount. The original intention of the section 1603 grant program was to make funding available sooner for renewable energy projects, by requiring payment within 60 days after the property is placed in service.[2] But unlike the nonrefundable energy tax credit, the grant is not limited by the passive activity rules or the 25-percent-of-tax limitation.

The section 1603 grant has some limitations. It is subject to the same "at-risk" and recapture rules applicable to the energy tax credit. Governments and tax-exempt entities cannot claim the grant. If a tax-exempt entity is a partner in a partnership, that partnership cannot claim the grant at all. In contrast, taxable partners may claim their pass-through share of the energy tax credit for the partnership's energy property even when there are tax-exempt partners in the partnership.

REITs are subject to special restrictions under both the energy tax credit and the section 1603 grant. If a REIT reduces its taxable income to zero with the dividends-paid deduction by distributing all of its income to shareholders, it cannot claim any energy tax credits or section 1603 grants.

The section 1603 grant program will expire January 1, 2011. Although legislation proposed in February 2010 would extend the grant deadline to January 1, 2013, the bill is still in committee and might not be enacted.[3] So time is running out for commercial real estate owners to take advantage of a government incentive that is far less restrictive than is usually the case.

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[1] It is assumed that the property is depreciated using the half-year convention and the 200% declining balance depreciation method.

[2] Or 60 days after the grant application date if later than the placed-in-service date.

[3] The proposed legislation (H.R. 4599) would also eliminate the grant restrictions for REITs and permit partnerships with tax-exempt partners to claim a pro rata amount of the grant.