Tax Opportunities for 360 California Companies' Cap and Trade Compliance

By Charles Goulding and Taylor Goulding

Charles and Taylor Goulding discuss California's statewide cap on the emissions that make up 80 percent of the state's greenhouse gas emissions. For the 360 businesses affected by the resolution, implementing the necessary emission reduction investments and offsetting solutions to comply with state regulations affords major tax opportunities.

On December 16, 2010, the California Air Resources Board (ARB), which is essentially California's EPA department, endorsed the state's cap and trade regulations. The measure sets a statewide cap on the emissions responsible for 80 percent of California's greenhouse emissions. The resolution covers 360 businesses, including 600 facilities. Tax advisers for the 360 companies should be engaged in integrating the major tax opportunities related to implementing the necessary emission reduction investments and offsetting solutions.

Tax Opportunities

Pursuant to Code Sec. 179D, as promulgated by the Energy Policy Act (EPAct), buildings making qualifying energy-reducing investments in their new or existing locations can obtain immediate tax deductions of up to $1.80 per square foot.

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If the building project does not qualify for the maximum $1.80 per square foot immediate tax deduction, there are tax deductions of up to $0.60 per square foot for each of the three major building subsystems: lighting, HVAC (heating, ventilating and air conditioning) and the building envelope. The building envelope is every item on the building's exterior perimeter that touches the outside world including roof, walls, insulation, doors, windows and foundation.

Alternative Energy Tax Credits and Grants

There are multiple 30-percent or 10-percent tax credits available for a variety of alternative energy measures with varying credit termination dates. For example, the 30-percent solar tax credit expires January 1, 2017, and the 10-percent Combined Power tax credit also expires January 1, 2017. The 30-percent closed-loop and open-loop biomass credit expires January 1, 2014.

All alternative measures that are eligible for the 30-percent and 10-percent tax credits are also eligible for equivalent cash grants for the three years staring January 1, 2009, and ending December 31, 2011.

Enhanced Bonus Tax Depreciation

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (``2010 Tax Relief Act")[1] provides for 100-percent tax depreciation bonus for equipment placed in service after September 8, 2010, through December 31, 2011. For equipment placed in service after December 31, 2011, through December 31, 2012, the new law provides for a 50-percent tax depreciation bonus.

sources during the initial period from 2012 through 2014. Entities that need additional allowances can buy them at quarterly auctions to be conducted by the ARB or buy them on the open market. Eight percent of a company's emissions can be offset utilizing credits from compliance grade projects in the forestry and agricultural sectors.

A rule set is outlined for providing offset credits in forestry management in urban forestry, dairy methane digesters and the destruction of existing banks of ozone-depleting substances in the United States. The ozone-depleting opportunities primarily involve

Exhibit 1. California Source of Emissions Implementation Timetable

California's Timing and Point of Regulation by Emissions Source		
Sources of Emissions	**Point of Regulation**	**Year Entering the Program**
In-State Electricity Generation	Those who generate electricity in-state and deliver it to the California electricity grid	2012
Imported Electricity	First deliverers of electricity to the California electricity grid	2012
Industrial – Combustion and Process Emissions	The source for large stationary combustion and process emission sources	2012
Carbon Dioxide Suppliers	Those who supply carbon dioxide	2012
Commercial/Residential/and small Industrial Suppliers	Where fuel is distributed, including natural gas local distribution companies (LDCs) and natural gas transmission pipelines	2015
Liquefied Petroleum Gas Combustion	Those who import or produce liquefied petroleum gas, including fractioners or refiners	2015
Transportation Fuel Combustion	Enterers and position holders of transportation fuels, and producers of biomass-derived fuels	2015

How the Cap and Trade Program Works

The underlying California bill (AB32) sets a statewide limit on the emissions from the largest generators responsible for 80 percent of California's greenhouse gas (GHG) emissions and establishes a price signal to drive long-term investment in cleaner fuels. The cap declines each year and uses allowances to limit GHG emissions. One allowance equals one ton of GHGs. Entities subject to the law must either reduce emissions or compete for a decreasing supply of allowances. The program is designed with the goal of providing covered entities the lowest cost options to reduce emissions. Each year, the total number of allowances issued in the state gets reduced. The goal is that by 2020, there will be a 15-percent reduction in GHGs compared to today to achieve the same level of emissions as the state experienced in 1990.

To manage the transition, ARB states that they will provide significant free allowances to all industrial

prior generation refrigerants in older refrigeration and air conditioning systems.

Utility Electricity Generators

Including the electrical utilities in the initial 2012 compliance group should kick start the program since utilities are quite familiar with the available emission reduction solutions and can utilize a variety of special tax incentives, some tailored for their industry to implement the necessary solutions. For example, utilities can now take advantage of the 30-percent tax credit for large scale solar photovoltaic (PV) installations at customer locations. These transactions help both the utility and the customer. The utility meets some of its cap and trade obligations, and the customer locks in lower-than-market electricity cost for an extended time period.

Coal-fired utilities are one of the biggest emissions generators. As a solution to reduce coal plant carbon dioxide emissions, a company can replace coal

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California Cap and Trade Tax Enhanced Emission Reduction Solutions		
Large Emitter Category	Emission Reduction Potential Solution	Tax Opportunity
Utility	Direct solar PV ownership at customer site	30% solar PV tax credit and large depreciation deduction
Utility	Increased rebates for commercial building energy efficiency	Section 179D EPAct tax deduction for customer base
Utility	Conversion of coal fire plants and biomass	30% biomass tax credits
Integrated Oil Company	Energy efficiency investments at gasoline stations and convenience stores (including solar PV roof canopies)	30% solar PV tax credits, large depreciation deductions and Section 179D EPAct tax deductions
Industrial	Investment in combined heat and power co-generation systems and facility energy efficiency measures	10% combined heat and power tax credits and section 179D EPAct Tax Deductions

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with biomass. Southern Company has already engaged in biomass conversion projects, including a project with its Georgia Power subsidiary. Furthermore, Southern Company is evaluating converting five additional coal plants to biomass.[2] Qualifying closed-loop and open-loop biomass projects completed before January 1, 2014, are eligible for a 30-percent alternative energy tax credit.

The following chart illustrates some of the tax effective strategies some of the California emission generator categories can consider implementing:

Multiple Strategy Approach

The scope of emission reduction required is so great for some of these facilities that a variety of solutions over multiple years will be required.

Solutions will include:

- investments in existing properties to reduce emissions;
- shutting down all or a portion of high emission generation facilities;
- internal cap and trade–using the company's own entities to reduce emissions;
- external third-party cap and trade

The rules in this article are new and evolving. Facility owners will need to consult cap and trade experts and tax advisers who are closely monitoring developments in this area.

Concurrent Tax Planning for California and EPA Guidelines

A week after the California ARB issued its endorsement, the federal EPA announced its landmark plan also aimed at the nation's largest GHG emitters. The agency said it will announce a common sense approach and similarly will propose standards for power plants in July 2011 and refineries in December 2011. This means that the largest California emitters in these two business segments should strive to implement solutions that simultaneously meet both the increased federal and California emission standards.

Conclusion

California and the EPA are following the global trend and steadily seeking to curtail GHG emissions. The 360 California companies have a variety of tax incentives they can use to help manage the process. Successful solutions will serve as case studies for the rest of the country confronting the same emission reduction obligations.

Endnotes

1 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312).

2 "Southern Company Breaks Ground on Biomass Plant," *PR Newswire*, Nov. 10, 2009; available online at *www.prnewswire.com/news-releases/southern-company-breaks-ground-on-biomass-plant-69671882.html*.