



# Monetizing Biodiesel Projects With Federal and State Income Tax Credits

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Reznick Group

Renewable Energy Tax Credit Services



## Overview of Reznick Group

- Ø The 17<sup>th</sup> Largest Public Accounting, Tax, and Business Advisory Firm in the United States
- Ø One of Only Two of the Twenty Largest US Accounting Firms to be Designated One of the “Top 25 Best Managed Accounting Firms” in the Nation by Our Peers
- Ø Registered With the PCAOB and Also Admitted for SEC Practice for Public Companies
- Ø Over 1000 Employees Nationally and Nearly 80 Partners
- Ø Offices in Atlanta, Charlotte, Baltimore, Washington DC, Chicago, Austin, Northern Virginia, Los Angeles and Sacramento



## The Types of Clients We Serve

Energy Project Developers

Tax Credit Investors

Private Equity Firms

Investment Funds

Investment Banks

Lending Institutions

Technology Groups

Insurance Companies

Real Estate Investment Trusts

Government Entities – Federal, State, County, and City

Nonprofits

Real Estate Developers, Property Owners, Managers

Hospitality and Lodging Groups



## Reznick Renewable Energy Related Services

### Client Benefits

- § Identification of particular tax incentives that can be incorporated into projects to reduce tax liability
- § Increased cash flow and profitability
- § Diversification of tax credit investments
- § Mitigation and understanding of risk using energy tax credits
- § Maximization of socially responsible "green" and renewable energy concerns



## Reznick Renewable Energy Related Services

### Reznick Group Services

#### Transaction Advisory

- § Transaction structuring
- § Project finance advisory
- § Due diligence
- § Compliance
- § Mergers and acquisitions
- § Implementation



## Biodiesel Tax Credit – IRC Section 40A

§ Interesting Credit

§ Biodiesel Mixture Credit - \$.50 per gallon

Ø Credit available to a blender for each gallon that is:

- Sold in a trade or business of the producer to any person for use as a fuel, or
- Used as a fuel in a trade or business of the producer

• Biodiesel Credit - \$.50 per gallon

Ø Credit available to a taxpayer for each gallon that is:

- Sells the biodiesel at retail and places the biodiesel in the fuel tank of the buyers vehicle
- Used as a fuel in a trade or business of the producer

• Note: In the case of both of the above credits, if the biodiesel is agri-biodiesel, the credit is \$1.00 per gallon vs. \$.50



## Biodiesel Tax Credit – IRC Section 40A (cont'd)

### § Small Agri-Biodiesel Producer Credit - \$.10 per gallon

Ø Producer has:

Ø Less than 60 million gallon productive capacity

Ø Credit is limited to the first 15 million gallons

Ø Definition:

- Any agri-biodiesel which is produced during the taxable year by a qualified small agri-biodiesel producer, and which during the taxable year:
  - Is Sold by such producer to another person:
    - For use by such other person in the production of a qualified bio-diesel mixture in such other person's trade or business
    - For use by such other person as a fuel in a trade or business
    - Who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person



## **Biodiesel Tax Credit – IRC Section 40A (cont'd)**

- § Allocated credit has to be picked up into income – IRC Section 87
- § Biodiesel Tax Credit is reduced to the extent Excise Tax Credits have been taken under IRC Section 6426
- § Biodiesel Tax Credit currently sunsets on 12/31/2008 unless legislation is passed to extend it



## Partnership or LLC As Choice of Entity

For tax credit monetization, a federal tax partnership is required.

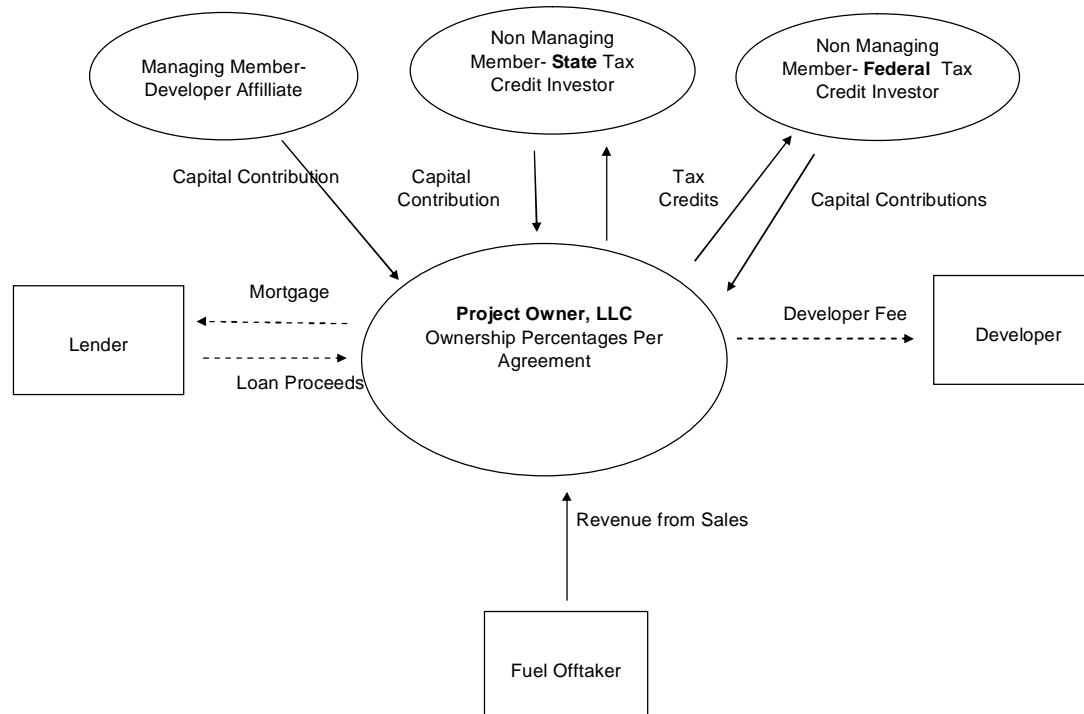
- ∅ No restriction on type of owners
- ∅ No restriction on number of owners
- ∅ Most freedom to allocate tax items and credits

Limited Liability Companies (LLC) are taxable as partnerships for federal and most state purposes if they have more than one true owner.



# What it "Looks" Like

## SINGLE ENTITY STRUCTURE





## Overriding Tax Issues

Federal Income Tax Issues:

- Ø Profit Motive
- Ø Economic Substance

State Tax Issues:

- Ø State Tax Credit Partnership Disregarded



## What Affects The Price Paid by Investors?

- § IRR
- § Mix of Return
- § Large Projects
- § Less Complex Projects
- § Local Profile of Project
- § Experienced Developers
- § High Operating and Replacement Reserves



## Investor Guaranties

- § provisions designed specifically to protect the limited partner's investment.
- § investors are interested in achieving the tax credits originally projected
- § Most investors are interested in the bona fide tax investment, and not necessarily in supporting the industry or "cause" for its own sake.



## Tax-Credit Shortfalls

- § Known as a tax benefit shortfall, in addition to the cost overrun and operating deficit guaranties, they typical tax credit agreement will include a provision known as a tax-credit adjuster.
  
- § A tax-credit adjuster reimburses the investment limited partner when it does not receive the tax credits it is expecting.



## Adjusters

- § If the tax credits bargained for are not received, the adjuster will serve to make up the tax investor's loss.
- § One strategy that many general partners employ is to be very conservative in estimating when the project will be constructed and geared-up. This might have the result, however, of causing the limited partner to reduce its investment in the project because the first-year credits are more valuable to it than credits that will be received in future years.



## Recapture of Credit

- § Mixtures:
  - Ø Any person:
    - Ø Separates the biodiesel from the mixture, or
    - Ø Without separation, uses the mixture other than as a fuel
  - Ø A tax will be imposed equal to the credit previously taken for the respective amount of mixture
- § Biodiesel:
  - Ø Any credit:
    - Ø was determined under this section with respect to the retail sale, and,
    - Ø any person mixes such biodiesel or uses such biodiesel other than as a fuel
  - Ø A tax will be imposed equal to the credit previously taken for the respective amount of biodiesel
- § Producer Credit:
  - Ø Any person does not use such fuel for a purpose described in the way the credit was generated
  - Ø A tax of \$.10 will be imposed on each gallon of respective agri-biodiesel
- § All taxes will be treated as if such taxes were imposed by IRC Section 4081 (Excise Tax)



## IRR Indemnification

- § Although generally not popular among syndicators, many private investment limited partners require an IRR indemnification.
- § The IRR indemnification requires that the project produce benefits to the investment limited partner over a fixed period of time.
- § The benefits come from three sources: income tax credits; tax losses, typically calculated using an assumed income tax rate, such as 35 percent; and cash flow.



## Buy-Back Rights

- § Most partnership agreements contain a provision requiring that the investor be bought out with interest if certain bad things happen.
- § The buy out provisions typically are triggered by events that affect the entire economic basis of the transaction, such as foreclosure, failure to complete construction, or a failure to obtain a majority of expected tax credits.
- § If the buy-out is triggered by less serious factors, such as a breach of a representation or warranty, the general partner should attempt to negotiate the removal of such a provision.



## **Risk for Changes to The Federal and Other Law Changes**

- § Who, the general partner or the investor, will bear the loss if the tax credit is retroactively eliminated by Congress?
- § What if the investor cannot use the tax credits because of technical tax rules, such as not having enough tax basis? Who bears that risk?
- § The guaranty provisions in the partnership agreement should clearly spell out who bears the risk in such events.



## Understanding Provisions Relating to Funding Guaranty Obligations

§ Guaranty payments owed to the limited partner are typically offset by the investment limited partner against future capital contributions. The construction lender is often concerned that offsets that have no limitation could deprive the project of sufficient funds to complete construction of the project. Most investment limited partners will go along with such a limitation. If there are no future capital contributions from which guaranty payments can be funded, the general partner is generally required to immediately write a check to the investor.

If the general partner must write a check, that check could be made directly to the investor as a penalty or guaranty payment, or it could be made as a capital contribution or subordinated loan to the partnership, which in turn could make the payment to the investor. How the payment is structured can have a significant effect.



## Disclaimer

Tax-credit partnerships are intricate and complicated documents. There are many subtleties in their drafting that cannot be fully appreciated without substantial experience. After all, the parties are often entering into a multimillion-dollar relationship that will probably endure for many years. Developers and General partners are strongly encouraged to negotiate with the assistance of experienced accounting and legal counsel. This material is neither legal nor tax advice and cannot be used or relied upon as such. All the above should be considered only as a starting point to isolate the many issues that must be carefully reviewed when entering into the complex relationship set forth in a typical income tax credit partnership agreement. There are other unique issues that specifically apply to a Biodiesel project that are not mentioned here. Feel free to contact Reznick group should you have additional questions.



## Contact

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