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# TAX INFORMATION RELEASE NO. 2010-10

October 13, 2010

Re: Common Income Tax & General Excise Tax Issues Associated with the Renewable Energy Technologies Income Tax Credit, HRS § 235-12.5

The purpose of this Tax Information Release (TIR) is to provide guidance on the Department of Taxation's (Department) interpretation of common Hawaii income tax and general excise tax issues that arise when taxpayers claim the Renewable Energy Technologies Income Tax Credit (Energy Credit) set forth at Section 235-12.5, Hawaii Revised Statutes (HRS).

## I. What are the Nonrefundable/Refundable Mechanics of the Energy Credit?

Section 235-12.5, HRS, provides a unique opportunity for taxpayers installing and placing in service certain renewable energy systems to elect whether the Energy Credit is utilized in a nonrefundable or refundable form.

Unless the taxpayer otherwise elects, the Energy Credit is considered nonrefundable and is utilized to offset a taxpayer's tax liability in the year the system is placed in service, with any excess in credit carried forward to future tax years.

If a taxpayer makes a proper election, the taxpayer may choose to have the Energy Credit refunded to the taxpayer in the form of a cash payment, after first being used to offset Hawaii tax liability, if any. This latter refundable option requires a reduction in the eligible credit amount, which is discussed in further detail at Part XI, below. For entities taxed as partnerships, the character of the credit (*i.e.*, nonrefundable or refundable), including any required reduction in the credit amount, is determined at the partner level for each separate taxpayer treated as a partner. For additional information on a partnership's distribution of the Energy Credit and a partner's commensurate claim of the credit, please see the appropriate instructions that accompany Form N-342, *Renewable Energy Technologies Income Tax Credit*, and Form N-342A, *Information Statement Concerning Renewable Energy Technology Income Tax Credit for Systems Installed and Placed in Service on or after July 1, 2009*.

The specific authority for the nonrefundable/refundable mechanics is provided in HRS § 235-12.5:

(f) If the tax credit under this section exceeds the taxpayer's income tax liability, the excess of the credit over liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted, unless otherwise elected by the taxpayer pursuant to subsection (g) or (h).

* * * * *

(g) For solar energy systems, a taxpayer may elect to reduce the eligible credit amount by thirty per cent and if this reduced amount exceeds the amount of income tax payment due from the taxpayer, the excess of the credit amount over payments due shall be refunded to the taxpayer; provided that tax credit amounts properly claimed by a taxpayer who has no income tax liability shall be paid to the taxpayer; and provided further that no refund on account of the tax credit allowed by this section shall be made for amounts less than $1.

* * * * *

(h) Notwithstanding subsection (g), for any renewable energy technology system, an individual taxpayer may elect to have any excess of the credit over payments due refunded to the taxpayer, if:

(1) All of the taxpayer's income is exempt from taxation under section 235-7(a)(2) or (3); or

(2) The taxpayer's adjusted gross income is $20,000 or less (or $40,000 or less if filing a tax return as married filing jointly);

provided that tax credits properly claimed by a taxpayer who has no income tax liability shall be paid to the taxpayer; and provided further that no refund on account of the tax credit allowed by this section shall be made for amounts less than $1.

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## II. Is the Energy Credit Subject to Hawaii Income Tax When Used as a Nonrefundable Credit?

**NO, A NONREFUNDABLE CREDIT IS MERELY A REDUCTION IN TAX LIABILITY.**

Gross income, as defined by Section 61 of the Internal Revenue Code of 1986, as amended (IRC), is subject to Hawaii income tax, unless otherwise exempt. Gross income means "income from whatever source derived," and has been defined to include all "undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion." IRC § 61(a); *Commissioner v. Glenshaw Glass Co.*, 348 US 426 (1955).

The Internal Revenue Service (IRS) recently published guidance analyzing the federal income taxation of state and local tax incentives, including state government tax credits. This guidance provides an instructive analysis on the taxation of state tax incentives because Hawaii law conforms to federal income tax law. *See Coordinated Issue Paper, State & Local Location Tax Incentives*, LMSB-04-0408-023 (May 23, 2008) (*hereinafter* CIP on Incentives). The Energy Credit, to the extent the credit is nonrefundable, is not subject to Hawaii income tax because the credit is merely a reduction in tax liability.

When a taxpayer is entitled to a tax abatement, credit, deduction, rate reduction, or exemption, the taxpayer generally is not regarded as realizing an accession to wealth that results in gross income. A state or local tax benefit of this type is applied against the taxpayer's current or future state tax liability, and is treated for federal income tax purposes as a reduction or potential reduction in the taxpayer's state or local tax liability.

CIP on Incentives. *See also Snyder v. Comm.*, TC Memo. 1988-320, *vacated and remanded*, 894 F.2d 1337 (6th Cir. 1990) (finding that a local tax incentive did not result in "income" because there was no right to receive any actual money, only a reduction in liability).

The Department adopts the analysis of the IRS as it applies to the income taxation of nonrefundable credits. The Energy Credit utilized in nonrefundable form is not subject to Hawaii income tax because nonrefundable credits merely reduce tax liability and do not result in actual money received from the government.

## III. Is the Energy Credit Subject to Hawaii Income Tax When Used as a Refundable Credit?

**YES, THE ENERGY CREDIT IS SUBJECT TO INCOME TAX TO THE EXTENT THE REFUNDABLE CREDIT EXCEEDS A TAXPAYER'S TAX LIABILITY.**

**A TAXPAYER IS ENTITLED TO BASIS BECAUSE THE ENERGY CREDIT IS INCLUDED IN INCOME.**

In addition to the Coordinated Issue Paper discussing state and local tax benefits, the IRS also recently published guidance in the form of legal advice provided to field attorneys with the Office of Chief Counsel. The Department agrees with the IRS' conclusion that a refundable state tax credit is subject to income tax to the extent the refundable credit exceeds the taxpayer's tax liability.

### A. Bifurcated Approach to the Taxation of the Energy Credit.

In a memorandum from the Office of Chief Counsel, the IRS' position takes a "bifurcated approach," looking to the application of the refundable credit against the taxpayer's ultimate liability:

> Case law has not addressed the federal tax treatment of refundable state tax credits, and the Service and the Treasury Department have not issued published guidance addressing the treatment of such credits. However, some informal nonprecedential advisories issued by the Office of Chief Counsel have applied an approach whereby a refundable credit is "bifurcated." That is, refundability, by itself, does not cause the entire credit to be treated as a payment from the state. Instead, the portion of the credit that is applied to reduce tax before the tax becomes due is still generally treated as a reduction in tax...only to the extent the credit exceeds the tax liability and is made available to the taxpayer as a cash payment is it treated as a payment from the state, includible in income unless some exclusion applies. Because such a payment is not actually a refund of prior taxes paid, it is not treated as a tax refund potentially excludable under § 111.

LAFA 20085201F (December 26, 2008). Applying the "bifurcated" analysis to the Energy Credit election for a refundable cash payment, the Energy Credit will be subject to Hawaii income tax to the extent the credit exceeds the taxpayer's offset tax liability and actually results in a cash payment.

The analysis under this Part is demonstrated by the following example:

> **EXAMPLE 1—**ABC Renewable Energy Co. installs and places in service a solar energy system that, after making the appropriate election, generates a refundable income tax credit claim of $15,000. ABC Renewable Energy Co. has a Hawaii income tax liability of $5,000 for the taxable year in which the credit is claimed. Under HRS § 235-12.5(g), the excess of an elected refundable credit after tax payments due is payable to the taxpayer. Under the bifurcated approach adopted in this TIR, the $15,000 credit claim is first applied to the $5,000 in tax payments due for the taxable year, which is not subject to income tax as discussed in Part I. The remaining $10,000, which is to be paid to ABC Renewable Energy Co., is treated as a taxable payment from the State.

For purposes of the Energy Credit, the Department adopts the bifurcated analysis of refundable tax credits by first allowing the offset of any tax liability to be exempt from income tax as a reduction in liability, with the remaining credit paid to a taxpayer being subject to income tax. The Energy Credit, to the extent it is refunded to an electing taxpayer, is taxable income.

B. Section 118 Nonrecognition Provision Does Not Apply.

An important corollary issue is whether the refundable Energy Credit payment is considered a nontaxable contribution to capital by the government under Section 118 of the Internal Revenue Code. The refundable portion of the Energy Credit is not exempt from tax as a contribution to capital.

Section 118 of the Internal Revenue Code provides that a non-shareholder's contribution to capital of a corporation is not income. Taxpayers in the past have argued that government payments should be considered such a contribution to capital and thus not subject to income tax. However, government "[p]ayments cannot qualify as contributions to capital [under § 118] where the payments 'might be used for the payment of dividends, of operating expenses, of capital charges, or for any purpose within the corporate authority, just as any other operating revenue might be applied.'" FLFA 20085201F (citing *Texas & Pacific Railway Co. v. US*, 286 US 285, 290 (1932)). Also, payments received from the government that are not "bargained for" do not constitute contributions to capital. *See id.* (citing *US v. Chicago, Burlington, & Quincy Railroad Co.*, 412 US 401 (1973). Applying these principles to the Energy Credit, there are no restrictions on the use of the refundable portion of the credit. Further, the receipt of the Energy Credit is not bargained for. Because it is possible—if not highly likely—for taxpayers to utilize the cash refund for dividends, operating expenses, or capital charges; and because the cash refund is not bargained for, the Energy Credit cannot be excluded from income as a non-shareholder contribution to capital under § 118.

C. Basis is Not Reduced Because of the Refundable Credit.

As a general rule, basis equals the cost of the property. *See* IRC § 1012. Section 1012 of the Code provides that "the basis of property shall be the cost of such property." The US Supreme Court has interpreted this phrase to mean the "cost to the taxpayer." *Detroit Edison Co. v. Comm*., 319 US 98 (1943). In the *Detroit Edison* case, the Supreme Court confirmed "that the taxpayer's outlay is the measure of his recoupment through depreciation accruals," which are determined by basis. *Id*. Receipt of reimbursement for an outlay in the form of a tax credit does not reduce a taxpayer's cost basis if the reimbursement is subject to tax. A taxpayer will receive basis in the renewable energy system to the extent of the taxpayer's actual outlay, which is not reduced by receipt of the Energy Credit in refundable form, because the cash payment is subject to income tax.

## IV. Is the Energy Credit, When Refunded to a Taxpayer, Subject to the General Excise Tax?

**NO, REFUNDABLE RENEWABLE ENERGY TAX CREDITS ARE NOT TAXABLE UNDER CHAPTER 237, HRS.**

The general excise tax is a tax on the privilege of doing business in Hawaii. The tax applies to gross receipts derived from conducting business. The receipt of Energy Credit from the government does not constitute "gross income" within the meaning of HRS § 237-3 because the payments are not derived from business conducted in Hawaii. The refundable Energy Credits are not paid as a result of conducting business in Hawaii, but are payments to induce a taxpayer to install renewable energy systems. Therefore, the refundable portion of the Energy Credit will not be subject to general excise tax.

## V. Is the ARRA Federal Cash Grant Subject to Income Tax?

**NO, HAWAII CONFORMS TO FEDERAL LAW EXCLUDING THE GRANTS FROM INCOME TAX**.

Section 48(d)(3), IRC, as amended by the American Recovery & Reinvestment Act of 2008, Public Law 111-5 (ARRA), provides that the federal cash grant under Section 1603 of ARRA is not subject to federal income tax. Act 112, Session Laws of Hawaii 2010, adopted the amendments to Section 48(d)(3), which conforms Hawaii income tax law to federal income tax law. Because Hawaii law conforms to federal law, the ARRA federal cash grants are not subject to Hawaii income tax.

## VI. Is the ARRA Federal Cash Grant Subject to General Excise Tax?

**NO, AS A GRANT IN LIEU OF A TAX CREDIT, THE ARRA GRANT IS NOT SUBJECT TO GENERAL EXCISE TAX.**

Section 1603 of ARRA provides for a grant in lieu of tax credits for persons who place in service specified energy property. The ARRA grant is not subject to general excise tax because, as a tax credit substitute, such amounts are not considered gross income within the meaning of HRS § 237-3. *See* Part IV, above.

## VII. For Purposes of Calculating the Energy Credit, is the "Actual Cost" of the System Reduced by the Energy Credit or the ARRA Federal Cash Grant?

**NO. THE ENERGY CREDIT AND THE ARRA CASH GRANT ARE NOT CONSUMER INCENTIVES OR UTILITY REBATES THAT WOULD REDUCE THE "ACTUAL COST" OF THE SYSTEM.**

In order to calculate the Energy Credit under HRS 235-12.5, a taxpayer must arrive at the system's "actual cost."

"'Actual cost' means costs related to the renewable energy technology systems...but not including the cost of consumer incentive premiums unrelated to the operation of the system or offered with the sale of the system and costs for which another credit is claimed under [chapter 235, HRS]." HRS 235-12.5(c). Moreover, "the dollar amount of any utility rebate shall be deducted from the cost of the qualifying system and its installation before applying the state tax credit." HRS 235-12.5(d).

The limitations relating to consumer incentives and utility rebates do not apply to the determination of a renewable energy technology system's actual cost for purposes of the Energy Credit claim.

A "consumer incentive" within the meaning of HRS § 235-12.5(c), includes a commercial price break by a dealer of systems that accompanies the sale of the system. The examples in the instructions to Form N-342 characterize such disqualifying costs components as "free gifts," offers to pay electricity bills, or rebates.

Furthermore, the limitation relating to utility rebates must be provided by a utility in order for the cost to be reduced. Any rebate from a source other than a utility would not fall within the meaning of "rebate" for purposes of HRS § 235-12.5(d).

Considering an objective reading of the law, coupled with the examples already established in Department literature, it is evident that the determination of "actual cost" is to be made by considering commercial consumer-like price cuts or bonuses that would be received in the wholesale or retail transaction of the system, such as "free gifts." Also, the "rebate" for purposes of the limitation in subsection (d) must be provided by a utility. Cash grants or tax credits directly provided by the government do not reasonably fall within the meaning of the restrictions associated with arriving at a system's "actual cost."

Based on the analysis above, the ARRA cash grants and Energy Credits do not reduce a system's "actual cost" within the meaning of HRS 235-12.5, nor are such amounts "utility rebates."

## VIII. Is a Taxpayer's Basis in a Renewable Energy Technology System Reduced by the Amount of the ARRA Cash Grant?

**NO. THE TAXPAYER DOES NOT REDUCE BASIS IN THE ENERGY SYSTEM BECAUSE HAWAII DOES NOT CONFORM TO THE CASH GRANT BASIS ADJUSTMENT RULES.**

Under the ARRA cash grant rules, § 48(d)(3)(B), IRC, provides that the grants shall be taken into account when determining basis, "except that the basis of such property shall be reduced under section 50(c)" 26 USC § 48(d)(3)(B). Section 50(c), IRC, reduces the basis in the energy property by 50% of the grant.

Hawaii tax law conforms to § 48(d)(3); however does not conform to § 50. "Reference in provisions of the Internal Revenue Code which are operative in this State to provisions in the Internal Revenue Code which are not operative in this State shall be considered inoperative for the purposes of determining gross income, adjusted gross income, ordinary income and loss, and taxable income." HRS § 235-2.5. A taxpayer will not be required to reduce a renewable energy system's basis by 50%, as required in § 50, because Hawaii law does not conform to the operative provision of the Internal Revenue Code that provides for the basis reduction. Therefore, a taxpayer's receipt of an ARRA cash grant shall not reduce the taxpayer's basis in the renewable energy system.

## IX. When Can Adjustments to Estimated Tax Payments be made if the Taxpayer will be claiming the Energy Credit?

**A TAXPAYER MAY ADJUST WITHHOLDING AMOUNTS OR ADJUST ESTIMATED TAX PAYMENTS ONCE THE TAXPAYER REASONABLY EXPECTS TO BE ENTITLED TO THE ENERGY CREDIT FOR THE TAXABLE YEAR.**

Sections 235-61 and 235-97, HRS, provide for the withholding of tax at the source and estimated payments of tax, respectively. For purposes of both withholding taxes and the payment of estimated taxes, reasonably expected or anticipated tax credit claims for the taxable year may be taken into account when figuring the amount to be withheld or paid. *See* HRS §§ 235-61(g), 235-97(f)(3).

Withholding certificates and estimated tax declarations may be modified depending upon a change in circumstances, including the reasonable expectation that the taxpayer will be entitled to claim certain tax credits during the taxable year. A taxpayer may adjust their withholding or estimated tax payments once the taxpayer is in a position to reasonably expect to claim the Energy Credit for the respective taxable year. The Energy Credit is claimable in the taxable year the energy system is placed in service. For more information on withholding taxes and estimated taxes, please see Forms HW-4, *Employees Withholding Exemption and Status Certificate*; N-1, *Declaration of Estimated Tax for Individuals*; N-3, *Declaration of Estimated Income Tax for Corporations and S Corporations*; N-4, *Statement of Withholding for a Nonresident Shareholder of an S Corporation*; and N-5, *Declaration of Estimated Income Tax for an Estate or Trust*.

## X. Is the Energy Credit subject to the Passive Activity limitations of § 469?

**NO. § 469 PASSIVE ACTIVITY LIMITATIONS DO NOT APPLY TO THE ENERGY CREDIT.**

Hawaii income tax law conforms to § 469 of the Internal Revenue Code. *See* HRS § 235-2.4 (x) (as amended by Act 112, SLH 2010). Section 469, among other things, places a limitation on the use of certain tax credits, limiting the use of such credits to offset passive activity income only.

The Energy Credit under Hawaii law is not one of the tax credits considered a passive activity credit under § 469. Moreover, Section 235-12.5, HRS, does not expressly characterize the Energy Credit as being a passive activity credit. Because there are no restrictions on the use of the Energy Credit under Hawaii law—by either reference to the Internal Revenue Code or by express operation of the credit itself—the Energy Credit may be used to offset any type of taxable income of a taxpayer (*i.e.*, whether passive or active).

## XI. How is the Energy Credit calculated for a Solar Energy System where the Election for a Refundable Credit is Made?

**THE REFUNDABLE ELECTION REDUCES THE CREDIT AMOUNT AFTER THE APPROPRIATE STATUTORY CAP IS APPLIED.**

Section 235-12.5(g), HRS, allows for a taxpayer installing and placing in service a solar energy system to elect to have the Energy Credit refunded to the taxpayer at a reduced credit amount. "For solar energy systems, a taxpayer may elect to reduce the eligible credit amount by thirty percent and if this reduced amount exceeds the amount of income tax payment due from the taxpayer, the excess of the credit amount over payments due shall be refunded to the taxpayer." HRS § 235-12.5(g). The election for a refundable credit reduces the ultimate credit amount—not the credit percentage.

The refundable credit election requires the taxpayer to reduce the eligible credit amount by 30%. The eligible credit amount is the lesser of:

> Eligible Costs, which is the product of the renewable energy system's cost, multiplied by the applicable credit percentage; or
> The credit cap.

Once the eligible credit amount is obtained, this amount is then reduced by 30% to determine the amount of reduced credit eligible to be refunded.

A. Determining the Eligible Costs.

Arriving at the eligible credit amount first requires a determination of the energy system's costs eligible for the credit. The Eligible Costs are arrived at by multiplying the solar energy system's cost by 35%.

System Cost
X 35% (Applicable Credit Percentage for Solar Energy Systems)
Eligible Costs

B. Lesser of Eligible Costs or Cap.

After arriving at the Eligible Costs allowable for the credit under subpart A., above, a taxpayer must then find the appropriate cap for the system at issue. (*i.e*, $5,000 per solar energy system for single-family residential property or $500,000 per solar energy system for commercial property (for uses other than to heat water for household use)).

The lesser of Eligible Costs or the Cap is allowed as the eligible credit amount. This amount is then reduced by 30% to convert it to a refundable credit.

C. Examples.

**EXAMPLE 2—Incorrect Calculation.** ABC Energy Co. installs and places in service a $2,000,000 commercial solar energy system. ABC Energy Co. elects to claim a refundable Energy Credit. In arriving at its credit amount, ABC Energy Co. multiplies the system's $2,000,000 cost by 24.5% (35% reduced by 30%) and arrives at a purported Eligible Cost amount of $490,000. Claiming the lesser of the $500,000 cap for commercial systems or the purported $490,000 Eligible Cost determination made by ABC Energy Co., ABC claims a credit of $490,000. This claim is incorrect and will be adjusted by the Department.

**EXAMPLE 3—Correct Calculation.** ABC Energy Co. installs and places in service a $2,000,000 commercial solar energy system. ABC Energy Co. elects to claim a refundable Energy Credit. In arriving at its credit amount, ABC Energy Co. correctly multiplies the system's $2,000,000 cost by 35% and arrives at an Eligible Cost amount of $700,000. A proper claim for credit in this case is the lesser of $500,000 or 35% of the solar energy system's cost ($700,000). Claiming the lesser $500,000, ABC Energy Co. then reduces the lesser $500,000 amount by 30% to arrive at its refundable amount. ABC Energy Co. is ultimately entitled to a refundable credit in the amount of $350,000 ($500,000 less 30%).

D. No 30% Reduction for Refundable Credits under 235-12.5(h).

Under § 235-12.5(h), taxpayers whose income is wholly exempt from taxation under §§ 235-7(a)(2) or (3) (certain retirement or pension income); or whose Hawaii adjusted gross income is $20,000 or less ($40,000 for a joint return), may elect a refundable credit for either a solar heating, photovoltaic, or, wind renewable energy technology system. The discussion regarding refundable credit reductions above is limited to elections for a refundable credit for solar energy systems for those not entitled to a refundable credit under subsection (h). There is no reduction in the credit claim for claims under subsection (h).

## XII. Effective Date.

This TIR is effective immediately and applies to all tax years where the statute of limitations on assessment or refund remains open. For more information, contact the Technical Section at 587-1577.

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