

ARE SOLAR REBATES AND GRANTS FOR HOMEOWNERS AND BUSINESSES TAXABLE?

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ABSTRACT

Financial incentives for solar installations are available in a growing number of states. Million Solar Roofs partners have questioned whether or not such grants and rebates are taxable at the federal or state level. If these incentives are taxable, it could mean as much as a 42% increase in a photovoltaic (PV) system's net cost for a homeowner relative to a case where the incentive is nontaxable.

Although there is strong evidence that residential incentives from utilities are nontaxable but those for commercial consumers are taxable, there are no clear guidelines on the tax treatment of state government rebates or grants. However, given the federal tax incentives available to businesses, and the rules against "double-dipping," the taxation of business incentives may actually help a project's bottom line.

This paper presents some of the federal tax code and guidance that may be relevant to determining taxability of incentives, highlights areas of ambiguity and confusion, and makes recommendations for resolving this issue.

Note: The authors are not credentialed to give tax advice! We urge incentive recipients to consult their tax advisor.

1. INTRODUCTION

Supported primarily by public benefits funds, nearly 20 states offer rebates or grants for PV projects; in about half of

these states, solar water heating projects are also eligible for incentives. In addition, over two-dozen utilities in 10 states provide customer rebates for PV and/or solar water heating installations. These programs, many of which have been established within the last several years, can play a significant role in solar deployment.

The uncertainty over the taxability of incentives has plagued the solar market in some areas of the country. The confusion has likely caused many system buyers to pay taxes they weren't obligated to pay, and may have soured some otherwise satisfied early adopters. In many cases, rebates and grants are designed to allow system owners to break even; taxing the incentive could significantly reduce the benefits of these programs. Million Solar Roofs partners, in an effort to maximize the benefits of incentive programs and other market transformation strategies, are seeking clarity on the tax treatment of incentives.

An informal survey of state incentive program administrators revealed that they are uncertain of the tax treatment of incentives and feel they have not received clear guidance on the issue. In some cases, state officials noted that even though the agency was unsure about taxability, an Internal Revenue Service (IRS) form 1099-G "Certain Government Payments" is sent to incentive recipients as a matter of policy implemented by the state's legal council.

There are several reasons that this practice/policy of "when in doubt, send a 1099-G out" should probably be challenged. First, unfortunately, many tax filers may claim all 1099 incomes without asking questions.

Second, this policy seems to contradict the instructions for Form 1099-G, which directs federal, state or local government agencies to report taxable grants:

*Enter any amount of a **taxable grant** administered by a Federal, state, or local program to provide subsidized energy financing or grants for projects designed to conserve or produce energy.... [1]*

Agencies required to file Form 1099-G must furnish a copy of the form or acceptable substitute statement to each recipient. Yet, it appears that some agencies are not sure whether the incentive payments are actually taxable.

Third, any organization that administers a federal, state or local governmental program that provides a **nontaxable** energy grant to a business must file a form with the IRS, implying that some incentives may indeed be nontaxable:

Any person who administers a government program for a Federal, state, or local governmental entity or agent of that entity that provides nontaxable energy grants or subsidized energy financing for section 38 property to business recipients under programs whose principal purpose is energy production or conservation must file Form 6497. [2]

This is used for business entities (including a sole proprietor). Section 38 property refers to the 10% business energy investment credit for solar and geothermal property as defined in Section 48. The value of a nontaxable grant must be subtracted from the equipment cost before calculating the tax credit. However, there is no requirement to tell the recipient that the grant is nontaxable.

Fourth, incentive programs can (and probably should) be designed to avoid any possibility that incentives are subject to federal tax.

Finally, the results of digging into tax law and questioning the IRS suggest that residential incentives (rebates, grants) may not be taxable under certain conditions. In contrast, businesses may actually have a greater overall tax advantage by claiming incentives as taxable income.

The bottom line is that solar purchasers should be advised not to assume that their incentive is taxable just because they receive a 1099-G documenting the incentive amount. Note, however, that the tax code is clear that *state tax credits* are considered taxable income for federal tax purposes. These credits are basically state taxes that an individual or business did not have to pay, and therefore, remain part of gross income for federal tax purposes.

In this paper, we'll attempt to (1) clarify whether or not rebates and grants for solar energy installations are or are not federally taxable; (2) illustrate the impact that federal taxes on incentives would have; and (3) identify areas where additional information is needed.

2. TAX TREATMENT OF RESIDENTIAL INCENTIVES

2.1 The Impact of Taxing Incentives

You might be saying to yourself, "How big a deal is this? Does it really impact the value or the marketability of solar energy systems?" Table 1 below was generated using the "Clean Power Estimator" [3] to show some of the differences in the economic indicators frequently used to make decisions about purchasing a 1-kW photovoltaic system depending on the tax treatment of the incentive. In this example, the pre-incentive cost is \$7,500, the tax bracket is 28%, and the system is financed at 7% interest for 30-year term.

TABLE 1: IMPACT OF FEDERAL TAX ON RESIDENTIAL INCENTIVES

State and Incentive	Net Cost after incentives		Increase in net cost
	Federally Nontaxable	Federally Taxable	
California CEC buydown	\$4,507	\$5,273	+17%
Vermont Renewable Energy Grant	\$4,944	\$5,644	+14%
Illinois RERP PV rebate	\$3,000	\$4,260	+42%
Rhode Island PV rebate	\$3,469	\$4,508	+30%

An increase of up to 42% in net cost significantly devalues the state or local incentive. So we get into a cycle - the tougher the market, the more generous the incentive, the larger the federal tax burden -- necessitating an even more generous incentives.

Although simple payback calculations do not capture the true value of solar and do not take into account inflation or the "cost of money," we recognize it is an economic measure used by many consumers. The increase in payback time in our examples ranged from one to four years.

Additionally, solar energy providers and others in the field need to be aware of these issues to better inform buyers and potential buyers of solar energy systems of the true costs, avoiding hidden costs.

2.2 Utility Incentives

There is strong evidence that utility rebates for residential solar projects are nontaxable. According to Section 136 of the IRS Code, energy conservation subsidies provided by public utilities, either directly or indirectly, are nontaxable:

Energy conservation subsidies. *You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.*

Energy conservation measure. *This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.*

Dwelling unit. *This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated. [4]*

Solar does fit the IRS definition of an energy conservation measure -- the direct result is to reduce the consumption of electricity and/or natural gas from the utility. PV in particular provides demand reduction benefits as well. Thus, it can be reasonably argued that utility rebates for solar installations on homes are nontaxable for federal tax purposes. Note, however, that in order to avoid "double dipping," the homeowner would need to reduce the basis of his or her property by the amount of the incentive payment.

Other types of utility subsidies that may come in the form of credits or reduced rates are also nontaxable, as the following IRS guidance states:

Utility rebates. *If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:*

- *A reduction in the purchase price of electricity furnished to you (rate reduction), or*
- *A nonrefundable credit against the purchase price of the electricity.*

The amount of the rate reduction or nonrefundable credit is not included in your income. [4]

2.3 State Incentives

State incentive programs that provide a taxable grant or other type of subsidy are required to inform recipients that the incentive is taxable. However, the tax code is unclear as to whether or not state government incentives are taxable. It may be reasonably argued, however, that these incentives are nontaxable for residential customers.

For example, since most state incentive programs are funded by system benefits charges collected by utilities and based on electricity usage, or established through utility settlements, one could reasonably conclude that these solar subsidies do come "indirectly" from a utility. Of course, it depends on what the IRS definition of "indirectly" is.

Some states have designed their programs to avoid the taxability issue. The Sustainable Development Fund in Pennsylvania, for example, designed a PV grant program to avoid taxation of the up-front portion of the incentive for the system owner by having the approved contractor receive the incentive and take it off the bottom-line cost to the consumer. Oregon's PV buydown is similarly structured. This mechanism avoids direct government payments to consumers. In contrast, other programs, including those in Illinois and New Jersey, send checks directly to the consumer.

What about incentives offered by state agencies via oil overcharge funds or state appropriations (not directly or indirectly from a utility)? One example is Vermont's new wind and solar incentive program. When queried about tax treatment of government subsidies for solar or conservation projects, IRS telephone and e-mail assistance provided conflicting information to the authors. This is still an open question that needs to be resolved.

Yet another tax provision may provide rationale for considering an incentive nontaxable in cases where a solar contractor who is considered a "dealer" provides a rebate to his or her customer: A cash rebate from a dealer or manufacturer is not considered taxable income, an exemption originally intended for car dealer rebates. Thus, in states where customers receive rebate checks from solar "dealers," one could argue that this cash rebate is nontaxable. In Vermont's case, program participants can choose to receive the incentive payment directly or through their contractor. Receiving the incentive through the contractor as a buydown of the installation cost or cash back may be the best option:

Cash rebates. *A cash rebate you receive from a dealer or manufacturer of an item you buy is not income, but you must reduce your basis by the amount of the rebate.*

Example. You buy a new car for \$9,000 cash and receive a \$400 rebate check from the manufacturer. The \$400 is not income to you. Your basis in the car is \$8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business. [4]

Two questions remain: (1) Does the "cash rebate" argument apply to the current structure of some rebate programs in which consumers receive rebates through solar equipment "dealers;" and (2) Are state rebates funded by system benefits charges collected by utilities considered subsidies provided "indirectly" by a utility?

Given that the solar industry is still faced with the "solar is too expensive" mentality, and PV customers are often plagued with cumbersome interconnection procedures and restrictive neighborhood architectural guidelines, it is important to clarify the tax treatment of incentives to avoid a needless increase in PV costs. Doing so will also allow incentive program administrators to design programs that maximize benefits to consumers.

2.4 Tax Treatment of Incentives at the State Level

States may handle the taxability question differently than the federal government. Some states have very clear language in their tax code. For example, California has language in the state's "Revenue & Taxation Code" stating that the solar rebates and incentives are not taxable for homeowners or businesses:

17138.1. *Gross income does not include any amount received as a rebate, voucher, or other financial incentive issued by the California Energy Commission, the Public Utility Commission, or a local publicly owned electric utility, as defined in subdivision (d) of Section 9604 of the Public Utilities Code, for any expenses paid or incurred by a taxpayer for the purchase or installation of any of the following devices: (a) A thermal system as defined in Section 25600 of the Public Resources Code. (b) A solar system as defined in Section 25600 of the Public Resources Code. (c) A wind energy system device that produces electricity. (d) A fuel cell generating system, as described in the California Energy Commission's Emerging Renewable Resources Account Guidebook, that produces electricity.* [5]

In contrast, other states, including Rhode Island and Illinois, follow the federal tax code to derive taxable income. The bottom line is that industry should advise their consumers to ask questions of their state or local government and of the IRS. Getting a 1099-G for the

incentive amount does not necessarily mean the incentive is taxable.

3. TAX TREATMENT OF BUSINESS INCENTIVES

There is plenty of good tax news for businesses, including:

- The 10% the Federal Business Energy Investment Credit for solar and geothermal property (see Form 3468 and its instructions); and
- Accelerated Depreciation: Under the Modified Accelerated Cost Recovery System (MACRS), businesses can recover investments in tangible property, including solar, wind and geothermal equipment, through depreciation deductions over a five year period. The MACRS deduction, plus a first year bonus depreciation of 50% now in effect for equipment placed into service between May 6, 2003 and January 1, 2005, can significantly impact the economic feasibility of solar equipment for businesses.

In general, any rebates received would be deducted from the installed cost before applying the 10% energy credit. With respect to the MACRS deduction, any nontaxable incentive reduces the basis for depreciation; that is, the incentive amount would be deducted from the installed cost before calculating the depreciation deduction. However, the depreciation basis is reduced by only 50% of the federal energy tax credit.

In addition, solar equipment qualifies for a Section 179 deduction. This deduction allows businesses to elect to recover all or part of the cost of certain qualifying property -- up to \$100,000 -- by deducting it in the year it is placed in service. Businesses can elect to take the Section 179 deduction instead of recovering the cost by taking depreciation deductions.

In IRS Publication 946 "How to Depreciate Property," energy property is even specifically excluded from the list of excepted lodging property (meaning solar investments can be deducted even when the equipment is connected with a property used for lodging.) That solar (and geothermal) is singled out for favorable treatment is certainly good news! The following excerpt from this publication gives the definition of energy property:

Energy property. *Energy property is either of the following types of equipment.*

- *Equipment that uses solar energy to generate electricity, to heat or cool a structure, to provide hot water for use in a structure, or to provide solar process heat.*

- *Equipment used to produce, distribute, or use energy derived from a geothermal deposit. For electricity generated by geothermal power equipment up to (but not including) the electrical transmission stage. [6]*

A tax advisor should be consulted to determine the most advantageous method for taking deductions.

3.1 Utility Incentives

Utility incentives for businesses to install solar or other energy conservation projects are taxable. IRS Section 136 originally provided a partial exclusion of energy conservation subsidies from taxable income for nonresidential units. However, the Small Business Job Protection Act of 1996 amended Section 136 and repealed the partial exclusion for property that is not a dwelling unit. Effective for subsidies received after December 31, 1996 (unless under a binding written contract in effect on September 13, 1995) the exclusion applies only with respect to dwelling units.

3.2 State Incentives

As is the case for residential incentives provided by state agencies, the tax code is unclear as to whether or not state government incentives are taxable for businesses. If state incentives passed through installers qualify as "cash rebates from manufacturers or dealers," then it may not be necessary to consider these incentives as taxable income. However, as the next section will illustrate, businesses may actually enjoy a greater tax advantage by claiming a rebate or grant as taxable income.

3.3 The Impact of Taxing Incentives

Given the way the energy tax credit calculation and MACRS depreciation work, claiming a utility or state incentive as taxable income does not necessarily reduce the economic feasibility of a project for the commercial sector. If the incentive is nontaxable, the basis for calculating depreciation deductions and the energy tax credit must be reduced. On the other hand, claiming the incentive as taxable income does not reduce the basis, and therefore, yields greater tax credit and depreciation deduction benefits.

Consider the example illustrated in Table 2 below in which the installed cost of a commercial solar project is \$100,000, the business receives a \$40,000 state rebate, and the tax rate is 34%. For simplicity, state taxes and depreciation benefits are not included.

A comparison of the net cost of the same project for which the incentive is taxable versus nontaxable illustrates that

claiming the incentive as taxable results in greater overall tax benefits and lower net project cost. In particular, note that the present value of the 5-year MACRS depreciation deduction is more than \$30,590 if the incentive is taxable, as compared to \$12,559 if the value of a nontaxable incentive reduces the basis for depreciation purposes.

TABLE 2: IMPACT OF FEDERAL TAX ON BUSINESS INCENTIVES

	Federally Nontaxable	Federally Taxable
System Cost	\$100,000	\$100,000
Rebate	\$40,000	\$40,000
Tax on Rebate	0	\$13,600
NPV of Tax Credit	\$5,808	\$9,680
Depreciation Basis	\$57,000	\$100,000
NPV of Depreciation Deductions	\$12,559	\$30,590
Net Cost	\$41,633	\$33,330

Although individual circumstances will vary and other incentives and tax liabilities may alter the level of benefits, this example shows that, in fact, businesses may have tax advantages if they claim an incentive as taxable income.

Finally, because different types of businesses -- C Corporation, S Corporation, Partnerships, and Sole Proprietorships -- may be subject to different tax rules, these entities are encouraged to consult their tax advisors to determine tax liability.

4. CONCLUSIONS

The research presented in this paper indicates that residential solar incentives provided by utilities are not subject to federal income tax. However, enough uncertainty remains regarding the taxability of state government incentives that definitive rulings on this issue are necessary to protect consumers and allow incentive program managers to design payment options that are the most advantageous to consumers.

The question of taxability for solar incentives for businesses is more complex, and there are situations where it may be a tax advantage to the business to claim the incentive as taxable income. The only thing that is clear is that the federal tax law should be clarified about how government incentive payments for solar installations should be handled. The following recommendations for action may help clarify this muddy issue:

- ❑ Work to have the tax code amended to clarify that state or utility incentives for residential solar projects (or other renewables) are not federally taxable. This is consistent with the other portions of the code that treat solar and geothermal energy favorably.
- ❑ Ask state and local governments who send out 1099-G forms to solar incentive recipients to share their reasoning for concluding that incentives are taxable.
- ❑ Find an entity that is willing to test the tax law by requesting a tax ruling, perhaps with the backing of the broader solar community, and disclose the rulings for the industry as a whole. A state agency or a group of state agencies could make this request as the issuing agencies for Form 1099s.
- ❑ Encourage stakeholders to submit the issue to the IRS's Systemic Advocacy Management System (SAMS) for issues that affect multiple taxpayer and are likely to need legislative or administrative fixes. [7] If the issue is presented from several different perspectives, it just might get resolved.

The following is what we submitted to the "SAMS" database. We will report on any progress at the ASES 2004 conference:

"Many state and local governments have incentive programs to encourage individuals and businesses to install solar (and other renewable) energy systems on their homes and businesses. There is distinct public benefit for this private action. Unfortunately, the tax code covers incentives by utilities for "energy conservation measures" (which appears to cover on-site production of solar energy) on dwellings, but fails to indicate if state and local government solar incentives should be similarly treated. It also fails to include structures other than dwellings.

This has been a source of confusion for government officials and taxpayers alike. When IRS is queried, they are unable to give advice based on the tax code. State governments sometimes send Form 1099-G to taxpayers, and sometimes not. We need to make the rules clear here and apply them consistently. Thank you for your help."

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