



The Enhanced Small Ethanol Producer Tax Credit I.R.C. Sec. 40(b)(3)

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The Renewable Fuels Association (RFA) is the national trade association for the U.S. fuel ethanol industry. Membership is comprised of numerous ethanol producers, both large and small, as well as suppliers to the industry and other interested parties. Founded in 1981, the RFA's primary objective is to promote public policy initiatives that increase the market for fuel grade ethanol produced from a variety of feed stocks including grains, agricultural wastes, and various biomass feedstock sources.

This document discusses the Small Ethanol Producer Tax Credit, and will assist small ethanol producers and tax advisors in better understanding the application of the credit.

The Small Ethanol Producer Tax Credit (SEPTC) has been in existence for many years and was initially introduced by Senator Bob Dole (R-KS) and passed as part of the Omnibus Budget Reconciliation Act of 1990. At that time this obscure credit was intended to provide a tax incentive for small producers. The initial legislation was well intended but riddled with technical difficulties and unintended results that hampered its effectiveness. For example, it did not envision the increase in farmer-owned ethanol plants. As a result, the credit has had limited use during the past fifteen years.

During the last decade significant effort has been expended by the Renewable Fuels Association to correct and improve the technical language and address unforeseen issues surrounding farmer cooperative ownership of ethanol plants.

Under the strong leadership of Senator Chuck Grassley (R-IA), the current chairman of the Senate Finance Committee, and with strong bipartisan support from both the House and the Senate, these efforts resulted in enhancements to the Small Ethanol Producer Tax Credit through legislation passed in the American Jobs Creation Act of 2004 (enacted 10-22-04) (P.L. 108-357) and the Domenici-Barton Energy Policy Act of 2005 (enacted 08-08-05) (P.L. 109-58).

Below is a summary of the general provisions of the Small Ethanol Producer Credit and the enhancements created by the new legislation.

- The general provisions of Sec. 40 provides for a Small Ethanol Producer Credit that allows an eligible small ethanol producer a nonrefundable federal income tax credit equal to \$.10 per gallon produced for the first 15,000,000 gallons. This equates to a maximum \$1,500,000 federal income tax credit annually for producers that produce at least 15,000,000 gallons.
- A small producer is defined as an ethanol production facility that has a productive capacity of less than 60 million gallons.

The American Jobs Creation Act of 2004 and the Energy Policy Act of 2005 have provided the following enhancements to the tax credit:

1. The definition of “small producer” was increased from an annual production capacity of 30,000,000 gallons to 60,000,000 gallons.
2. The production capacity limit applies at both the entity producer level and the entity owner level.
3. The federal tax credit was extended through December 31, 2010.
4. The SEPTC offsets alternative minimum tax (AMT) for years beginning after December 31, 2004.
5. Cooperatives are allowed to elect to allocate the tax credit to its patron members.
6. Unused credits can be carried back one year and forward for a maximum of 3 years beyond the statutory expiration date of the credit, currently December 31, 2013.
7. Unused credits will become an income tax deduction after the carry forward period has expired.

The Energy Policy Act of 2005 also created a new Small Agri-Biodiesel Producer Tax Credit under IRC Sec. 40A(a)(3), which provides for a nonrefundable federal income tax credit for producers of agri-biodiesel. The credit is \$.10 per gallon for the first 15,000,000 gallons of agri-biodiesel produced by small producers. Agri-biodiesel is defined as biodiesel derived solely from virgin oils. This credit was effective on the date of enactment August 8, 2005 and is scheduled to expire on December 31, 2008. This credit is subject to the same definitions and limitations as the Small Ethanol Producer Tax Credit.

The SEPTC has two limitations:

1. The SEPTC is generally limited to offset tax generated by passive activities.
2. The tax credit is subject to the taxable income add back provision of Sec. 87.

The limitations are further explained below.

Commonly Asked Questions & Answers

1. What is the small ethanol producer tax credit (SEPTC)?

The SEPTC allows an eligible small ethanol producer a nonrefundable federal income tax credit equal to \$.10 per gallon produced for the first 15,000,000 gallons. This equates to a maximum \$1,500,000 federal income tax credit annually for producers that produce at least 15,000,000 gallons.

2. What is a “small ethanol producer”?

A small producer is defined as an ethanol production facility that has a productive annual capacity of less than 60 million gallons (including denaturant). This is measured by the *greater* of the engineered boilerplate capacity of the plant or the actual production during the year.

This test is measured at the producer entity level and at the individual owner level.

For example, if the boilerplate capacity is 55 million gallons and the actual production capacity is 62 million gallons, then the plant would *not* be eligible to take the credit.

On the other hand, if the boilerplate capacity was 65 million gallons, but the plant only produced 55 million gallons, then again the plant would *not* be eligible to take the credit.

3. How does the SEPTC work?

In simple terms, if a small ethanol producer has taxable income of \$5,000,000.00 and a tax rate of 35%, then the tax liability of the producer is \$1,750,000.00. If the small ethanol producer elects to take the small ethanol producer tax credit up to the maximum amount of \$1,500,000, then the tax liability would be \$250,000.00 (keep in mind, there are other limitations to be considered, but this example should help you better understand how the credit is applied).

Taxable Income:	\$5,000,000
Tax Rate:	<u>35%</u>
Tax Liability	\$1,750,000
SEPTC	<u>(\$1,500,000)</u>
Tax Liability after SEPTC	<u>\$250,000</u>

4. How is my productive capacity measured if I have ownership in multiple plants?

You will be allocated production gallons proportionate to your ownership interest in each plant in which you have an investment. You must also include plants that you have an ownership interest in that do not qualify as a “small producer” when calculating your production gallons. Example: I own 5% of a 50,000, 000-gallon plant and a 10% interest in a 100,000, 000-gallon plant. You will calculate 5% times 50,000,000 = 2,500,000 plus 10% times 100,000,000 = 10,000,000 for a total productive capacity of 12,500,000 gallons.

Producer entities that make an investment in other producing plants must add the allocated production gallons that pertain to their ownership. Investors are subject to the controlled group and attribution rules of Sec. 267 which states that ownership of over 50% requires the entities to be considered as one controlled group for production limitation purposes.

5. What if our ethanol plant and the investors cannot use the SEPTC and do not want to be required to add the \$1,500,000 back to taxable income per Sec. 87?

The SEPTC is an annual election that is claimed at the entity level by recognizing the tax credit on the ethanol production company’s federal tax return. The SEPTC can be claimed or revoked within the 3-year statute of limitations by filing an amended tax return. The proper amended tax returns will be required to be filed by the owners of a pass through entity as well.

6. If I am subject to alternative minimum tax on a regular basis, will this credit be of any use to me?

Yes, the American Jobs Creation Act of 2004 provided for the SEPTC to offset alternative minimum tax in addition to regular federal income tax. This provision is still limited by Sec. 38(c)(4) which prohibits the SEPTC to reduce your regular income tax below 25% of the amount by which your regular income tax exceeds \$25,000.

7. What factors can reduce the amount of the credit?

The SEPTC is generally limited to offset tax generated by passive activities and the tax credit is subject to the taxable income add back provision of Sec. 87.

8. How do I add the SEPTC back into taxable income pursuant to Sec. 87?

The tax benefit of the SEPTC is somewhat reduced by the Sec. 87 requirement to add the amount of the tax credit into taxable income.

The Sec. 87 income add-back is excluded in computing the alternative minimum tax.

The amount of the SEPTC should be included in the producing entity’s other income and be included in the ordinary business income of the company.

It is important to note that the Sec. 87 add-back provision is invoked solely for income tax purposes. The add-back does not result in any additional assets for the company and does not increase a partner or members capital account. The Sec. 87 add-back must be included in regular taxable income and should increase the tax basis of the partner's or member's interest.

For example, if a project qualifies for the entire credit of \$1,500,000, the taxable income of the taxpayer will be increased by the same amount. If the taxpayer's marginal income tax rate is 35%, then the tax on the \$1, 500,000 will be \$525,000, which reduces the value of the credit to \$975,000.

9. Will the SEPTC add-back provision of Sec. 87 cost me additional state income tax?

The SEPTC add-back provision of Sec. 87 will increase the company's federal taxable income by \$1,500,000 if an ethanol plant takes the entire credit. Many states calculate their state taxable income by starting with federal taxable income. In the case when federal taxable income is the beginning of the state taxable income calculation, your state must have a specific subtraction for the SEPTC to negate the impact of this phantom state income. Some states have initiated corrective legislation to subtract the SEPTC and other states have taxed this income windfall. Contact your state legislators to ensure that your state has created a specific subtraction for SEPTC add-back provision.

10. Can investors use the SEPTC to offset all federal income tax liability or is it limited to tax generated from passive activities?

Most investors in ethanol production companies are considered passive investors.

Passive activities generally include activities conducted by pass-through entities such as LLC's, partnerships, or S-corporations, in which the owner investor does not materially participate in the management and operations of the company.

The SEPTC retains the character of the income that generated the credit. The SEPTC is limited per Sec. 469(d)(2) to the extent that the credit amount exceeds your regular tax liability allocable to all passive activities for the year. However, investors should also note that interest and dividend income, which are generally passive in nature, are not considered passive income, but portfolio income for this purpose.

11. Can the SEPTC be used as an investment tool for new investors?

Yes. Individual investors looking for offsets to passive income gains will be prime candidates to become new investors in small ethanol plants.

12. Can investors use the credit in more than one ethanol plant and receive more than the \$1,500,000 per year in credit?

Investors can invest in more than one ethanol plant, but the productive capacity for each investor is limited to 60,000,000 gallons. If an investor has in interest in multiple plants where the total productive capacity is less than 60,000,000 gallons and the income tax credit

for which the investor is eligible is greater than \$1,500,000 then the investor would also be limited to the \$1,500,000, which would equate to 15,000,000 gallons of production.

13. If our plant has different classes of partner-investors, may we allocate the SEPTC to one class of investor and the profits to a different class of investor?

No. The SEPTC is generated from the production and sale of ethanol. The Treasury Regulations require that because the credit is related to an item of partnership income (the sale of ethanol), the credit must be allocated to each partner in the same proportion as profits from the sale of ethanol are allocated. Similarly, the instructions to IRS Form 6478, *Credit for Alcohol Used as a Fuel*, provide that a partnership should allocate the SEPTC to each partner, "in the same way that income and loss are divided."

14. What does a cooperative have to do to allocate the SEPTC to its patron members?

Cooperatives are not considered pass through entities by the IRS, but rather corporations that receive a special dividend deduction when it operates on a cooperative basis. The SEPTC will be allocated proportionate to the income that is allocated to patron members. The cooperative must make an election to utilize the SEPTC and then make an additional election to pass the credit through to its patron members. The cooperative must also notify the members in writing that they have been allocated their proportionate share of the SEPTC. A cooperative is required to do this within 8 ½ months after the close of the fiscal year (after the election was made). Usually this is included on the written notice of allocation of patronage earnings. The election to allocate the SEPTC to the patron members cannot be revoked.

15. Can the credit be used even if neither the ethanol plant nor the investor has much tax liability?

The SEPTC can be elected to be used if neither the plant nor the investor has much tax liability. The plant would be required to add \$1,500,000 back into taxable income subject to the Sec. 87 addback. In the case where the plant is a pass through entity or cooperative, the credit will be passed through to the owners and can be utilized on their individual tax returns. To the extent the plant and the investors have no eligible tax liability to offset, the credit can be carried back one year and forward three years beyond the statutory termination date of this provision which is December 31, 2013.

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