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Biofuel Tax Incentives in Florida Agriculture: Are We Serious About Energy Independence?

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“We gotta get off oil, America has got to change its habits. It should be obvious to all, demand has outstripped supply, which makes prices go up.” George W. Bush, speaking to the Washington International Renewable Energy Conference, March 5, 2008.¹

In September 2008, Florida Governor Charlie Crist endorsed a plan to build an ethanol plant on land that the state of Florida is currently attempting to buy from U.S. Sugar.² In addition to the obvious motivations for this endorsement, including public sentiment towards the expense of the U.S. Sugar buyout and environmental concerns about the Everglades, positioning Florida as a biofuel powerhouse makes good sense economically. Florida has a vested interest in developing biofuels as an alternative to fossil fuels to provide for the increasing energy needs of the United States. Biofuels are fuels that are produced from agricultural and other organic materials such as ethanol. With the ability to grow a diverse selection of crops year round which may be used to produce alternative fuels, including corn, sugar, and timber, as well as the ideal weather conditions to plant as many as three crop rotations a year, Florida is singularly situated to provide a steady supply of the raw materials that biofuel producers will need. Given the strategic difficulties of transporting the amounts of biomass necessary to produce biofuels, Florida is an ideal location for the research into and production of biofuels.

Because of our position as an ideal location for the establishment of biofuel plants, it is important for tax practitioners in Florida to understand the current tax regime relating to biofuels, specifically as it relates and compares to the regime available for traditional fossil fuels. Considering the pivotal point at which the nation finds itself regarding energy dependence, the question is whether the United States is serious about energy independence and diversification. A review of the Tax Code leads one to a negative conclusion.

To frame the issue historically, it is important to understand that the federal government uses the Internal Revenue Code (the “Code”) to enact non-tax policy in two ways: through the imposition of taxes which act as disincentives to discourage undesirable behavior and through the creation of tax subsidies (such as deductions or credits to reduce taxes) which act as incentives to encourage desirable behavior.

Early tax energy policy focused on tax incentives to increase domestic fossil fuel production, such as the expensing of otherwise capitalized intangible drilling costs and the percentage depletion allowance, which served to reduce the marginal effective tax rates on the oil industry. Many of these tax incentives are still in effect in the Code, and the possibility of their repeal is being debated in the context of energy policy.

In the 1970s, tax energy policy began a shift towards conservation and a general acceptance that new forms of energy were needed. Therefore, certain disincentives were introduced in the Code related to fossil fuels. For instance, in 1980, Congress enacted a windfall profits tax, subsequently repealed in 1988,³ which was an excise tax on oil companies that applied to the difference between the market price of oil and a set base price. The idea of a windfall profits tax has also been much discussed in Washington recently.

In 1990, the General Accounting Office (“GAO”) cautioned that continued government incentives and/or a legislative requirement for the use of alternative fuels such as ethanol would be needed to maintain growth in domestic ethanol production,⁴ and in 1997, the GAO again cautioned that without ethanol tax incentives that allow ethanol to compete with gasoline, ethanol fuel production would largely cease.⁵

Additionally, there is evidence that the continued appropriateness of tax incentives for petroleum, with its already established market, is minimal at best. In 1990, the GAO expressed concern with “the effectiveness of the [petroleum incentive] provisions in terms of increasing long-term energy security. Reduced taxes for the petroleum industry would require higher taxes on other activities, increased federal debt or reduced federal spending. In addition, the increased exploitation of U.S. reserves during a period of relatively low oil prices that could be encouraged by incentives may be a security disadvantage.”⁶ The GAO went on to say that for an overall approach to energy security, attention needed to be paid to alternative fuels, conservation, oil storage, international coordination, and a stable economic and regulatory environment.

The evidence suggests, therefore, that the Code should reflect increased interest in developing alternative fuels such as biofuels, while discouraging domestic production of petroleum and fossil fuels. Therefore, a reasonable prediction would be that the Code would have multiple broad incentives for the discovery and production of biofuels in much the same way as, historically, there were multiple broad incentives for the exploration and production of fossil fuels. This, it turns out, is not the case.

Currently, the fossil fuel industry has a plethora of provisions related to the production of fossil fuels. To illustrate, following is a summary of a few of the incentives currently in effect related to oil: an enhanced oil recovery credit,⁷ a credit for producing low-sulfur diesel fuel,⁸ a credit for the production of oil and gas from marginal wells,⁹ an accelerated deduction for qualified refinery property,¹⁰ and the entire comprehensive regime of Subchapter I of the Code, titled “Natural Resources.”

On the other hand, the handful of tax provisions related to biofuels are both overly specific and woefully inadequate. All such provisions focus on the refinement of, or encouraging the use of, such alternative fuel sources, while none encourage the production of the raw product which is necessary to generate the alternative energy or fuel source. Most recently, three pieces of

legislation enacted tax provisions related to biofuels. As it stands, these are the only provisions specifically related to biofuel that are currently in effect in the Code. Once again, none are focused upon the producer or farmer who should be encouraged to shift or convert production to commodities or products which supply renewable energy sources.

The current tax scheme for renewable energy is of particular interest to Florida agriculture due to the impact on its agriculture from recent natural catastrophes: the hurricanes and tropical storms in 2004, 2005 and 2008, citrus canker, and citrus greening. Many agricultural properties are laying fallow, their owners still deciding whether and how to replant. Also, Florida agriculture is at a crossroads as to the crops necessary to produce and the infrastructure improvements needed to sustain a new renewable energy industry.

To aid Florida's agriculture industry with the expenses inherent in adopting and adapting to new production needs, tax incentives are needed. Examples of such tax incentives include the following: (1) relaxation of the capitalization rules under Section 263A for developing crops that have a preproductive period of greater than two years, especially expansion of the exception to capitalization rules found in Section 263A(d)(2) to allow citrus growers to replant crops other than citrus trees such as plants used in production of energy; (2) relaxation of the application of capitalization rules to the Section 175 soil and water conservation expense to encourage the necessary soil and infrastructure improvements to handle these new crops; (3) relaxation of the passive activity loss rules under Section 469 to encourage investment of capital by non-agricultural investors in the production of renewable energy source crops; and (4) provision of incentives similar to Section 631 allowing the characterization of revenues from the harvesting of renewable energy source crops to qualify for long-term capital gain treatment under Section 1231, rather than ordinary income treatment, similar to that allowable to harvesting of timber (which includes Christmas Trees).

These types of changes to the Code would provide significant incentives for agriculture, especially in Florida, to meet the growing need for reliable and renewable energy sources and provide the further intangible benefit to society of preserving more land in agricultural production. Unfortunately, looking at the provisions currently in place for biofuels, it is clear that the Code has a long way to go before it reaches the level of comprehensive incentives needed to enable Florida to take its place as a biofuel industry leader. Recent legislation in 2004, 2005, 2006 and 2008 which included biofuel provisions are an example of how out-of-touch the Code is with the needs of the modern farmer.

The American Jobs Creation Act of 2004¹¹ expanded a previously established volumetric ethanol excise tax credit, a 51 cent credit for each gallon of ethanol which gasoline suppliers blend with gasoline. The most recent Farm Bill¹² reduced the 51 cent per gallon credit to a 45 cent per gallon credit beginning in the calendar year 2009, with some complicated restrictions on the reduction based on a 7.5 billion gallon domestic ethanol production threshold. This recent piece of legislation is troubling because it works against the stated goal of the federal government to encourage alternative fuels by treating the biofuel incentives as a pocket to dip into for pay-as-you-go offsets.

The American Jobs Creation Act of 2004 also established a biodiesel tax credit, which allows biodiesel producers and blenders to claim a per-gallon tax credit for diesel fuels produced from agricultural products. These credits are found in Section 40.

The Energy Policy Act of 2005¹³ expanded the small ethanol producer credit, which may be claimed on the first 15 million gallons of ethanol produced by a small producer (i.e., an ethanol producer with production capacity below 60 million gallons per year) in any given year, as well as the small agri-biodiesel producer credit, which may be claimed on the first 15 million gallons of agri-biodiesel produced by a small producer in any given year. Additionally, the Energy Policy Act of 2005 established the renewable diesel tax credit, which is available for certain diesels produced from biomass that are not otherwise classified as biodiesels. These credits are found in Section 40A.

It should be noted that, as an unusual corollary of Sections 40 and 40A, Congress simultaneously gives and takes, having enacted Section 87, which requires that the amount of the alcohol fuel credit and the biodiesel fuels credit be included in gross income of the taxpayer, thus reducing their impact on the marginal tax rates of potential biofuel producers.

Finally, the Tax Relief and Health Care Act of 2006¹⁴ established an accelerated depreciation deduction for new cellulosic ethanol plants which break down cellulose through an enzymatic process (as opposed to gasification). This accelerated depreciation is only available to plants which are acquired after December 20, 2006 and before January 1, 2013. Any plant which had a binding contract for acquisition before December 20, 2006 does not qualify.

The biodiesel tax credit, small agri-biodiesel producer credit, and renewable diesel tax credit are scheduled to expire December 31, 2008. The volumetric ethanol excise tax credit and small ethanol producer credit are scheduled to expire December 31, 2010. The special depreciation allowance for cellulosic biomass ethanol plant property are scheduled to expire December 31, 2012. The self-expiring nature of these provisions, as compared to the fossil fuels provisions which have no such sunset, shows a failure to commit to long-term tax policy related to biofuels as an alternative energy source. To truly reflect a commitment to alternative forms of energy, Congress needs to enact open-ended legislation which will allow biofuel producers to predict tax savings into the future of long-term, risky projects.

As evidenced by this enacted legislation, the issue of the tax energy policy has been revisited in Congress time and time again in recent years. Most bills introduced have included a combination of incentives for the traditional fossil fuels and biofuels.¹⁵ However, there has been limited success in enacting the provisions, with the most recent, the Farm Bill effectively reducing incentives for ethanol and other biofuels.¹⁶

The glaring differences between the Code provisions relating to biofuels and the Code provisions relating to traditional fossil fuels show the lack of a comprehensive and committed plan with regard to the use of the Code in energy policy in the United States. If the United States is to become serious about encouraging alternative renewable energy sources such as biofuels, the Tax Code must be overhauled to provide the same level of long-term encouragement and incentives for investment in these renewable energy sources as has historically existed for discovery and harvesting of fossil fuels. To date, the efforts undertaken have been haphazard

and project specific, with almost exclusive focus upon the refinement and distillation processes for generation of renewable energy sources, and with little, if any, attention to the production of the renewable energy source supply required to feed these refineries and distilleries. This is where the opportunities in Florida are great, due both to the availability of usable land and the positive climate conditions supportive of production of multiple crops each year that could provide a reliable source of fuel for these refineries and distilleries.

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About Dean Mead:

Dean Mead is a commercial law firm that provides full-service legal representation to businesses and individuals throughout Florida. The firm has 50 lawyers practicing in Orlando, Fort Pierce and Viera.

¹ Bush: Use ethanol to get off oil. Hargreaves, Steve.

http://money.cnn.com/2008/03/05/news/bush_ethanol/index.htm (Retrieved September 25, 2008)

² Ethanol may fill sugar's place. Bousquet, Steve and Pittman, Craig.

<http://www.tampabay.com/news/environment/wetlands/article805326.ece> (Retrieved September 10, 2008)

³ P.L. 96-223

⁴ Alcohol Fuels: Impacts From increased Use of Ethanol-Blended Fuels. GAO/RCED-90-156, July 1990.

⁵ Tax Policy: Effects of the Alcohol Fuels Tax Incentives. GAO/GGD-97-41, March 1997.

⁶ Tax Policy: Additional Petroleum Production Tax Incentives are of Questionable Merit. GAO/GGD-97-41, July 1990.

⁷ Code Section 43

⁸ Code Section 45H

⁹ Code Section 45I

¹⁰ Code Section 179C

¹¹ P.L. 108-357

¹² P.L. 110-234

¹³ P.L. 109-58

¹⁴ P.L. 109-432

¹⁵ For a good summary of recent attempts at tax energy policy legislation, see: U.S. Congressional Research Service. Energy Tax Policy: History and Current Issues (RL33578; updated June 10, 2008), by Salvatore Lazzari.

¹⁶ See text accompanying Note 12.