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Baker Tilley International

August 15, 2005

International Automated Systems, Inc.
326 No. Hwy 198
Salem, Utah 84653

Dear Client,

You have asked us to advise you of the tax ramifications of a proposed lease of solar equipment by International Automated Systems, Inc (IAS) to potential investor groups, seeking to obtain the energy tax credit.

Proposed Transactions:

1. IAS would lease to a corporate customer its solar lens and heat exchanger under an lease term of 6 years. The customer would sublease to a power generating company, which would operate the plant. IAS would elect to pass through the energy credit to the customer/lessee. IAS would depreciate the leased equipment. The lessee would pay \$9,000 up front for the 6 year lease and receive the energy tax credit of \$9,000, passed through by IAS. At the end of the 6 year lease term, the leased property will remain with AS.
2. IAS would lease to an LLC customer its solar lens and heat exchanger under a six year lease term which would be paid up front. The total lease payment would be \$9,000. The LLC would receive the 30% energy tax credit on \$30,000 fair market value of the equipment.
3. IAS builds its own plant at fair market value and depreciates its cost. IAS would receive the 30% energy tax credit based on the cost of the equipment.

Law

Code Section 48(a)

The 2005 Energy Policy Act will increase the solar energy credit from 10% to 30% of the basis for solar energy property placed in service after December 31, 2005 and before January 1, 2008.

Qualified energy property means any property:

- (A) (i) equipment which uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, excepting property *used* to generate energy for the purpose of heating a swimming pool.
(ii) equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight but only with respect to periods ending before January 1, 2008
(iii) equipment used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electrical transmission state
- (B) (i) the construction, reconstruction, or erection of which is completed by the taxpayer, or
(ii) which is acquired by the taxpayer if the original use of such property commences with the taxpayer.
- (C) with respect to which depreciation is allowable, and
- (D) which meets the performance and quality standards prescribed by the Secretary and in effect at the time of the acquisition of the property.

Code Section 50(d)(5)

Refers to old code section 48(d)(5) which allows a lessor of qualified energy property to elect to pass the credit for the leased property to the lessee.

Code Section 48(d)

General rule-The lessor may elect to treat the lessee as having acquired the property for an amount equal to the fair market value of such property.

Special rule for short-term lease property-The rule applies only to property which: (A) is new qualified property; (B) has a class life in excess of 14 years; (C) is leased for a period which is less than 80 percent of the class life of such property; (D) and is not leased subject to a net lease. If this special short term lease *rule* applies, the lessee is treated as acquiring a portion of such property equal to a fraction, the numerator being the term of the lease and the denominator being the class life of the property leased,

Code Section 50(c)

Section 50(c) requires an adjustment to the basis of the energy property in the amount of 50% of the energy credit. The lessor that elects to pass the credit through to me lessee is not required to make this adjustment. However, the lessee is required to include ratably in gross income, over the shortest recovery period which could be

applicable under section 168 with respect to such property, an amount equal to 50% of the allowable tax credit. (Reg. 1.48-4(n))

Code Section 46(e)(3)

A non-corporate lessor is entitled to the investment credit with respect to qualified property not manufactured or produced by the non-corporate lessor and leased to others, only if the lease satisfies two requirements:

The term of the lease (including renewal options) is less than half the useful life (or ADR class life) of the leased property and

For the first 12 months after the property is transferred to the lessee, the Code *section 162 deductions allowed to the lessor with respect to the property (other than rental payments and reimbursed expenses)* must exceed 15% of the rental income produced by the property.

Code Section 167

Depreciation shall be calculated on the basis determined under Code Section 1012 which says the basis shall be the cost.

Code Section 168(e) & (e)(3)(B)

The class life of 5 year property is more than 4 years but less than 10.

Any property described in subparagraph (A) of section 48(a)(3) (solar and wind) falls into the 5 year property classification.

Code Section 469 & Reg 1.469

Losses from passive activities are not deductible against non-passive income, only against income generated by *passive income activities*.

Tax Credits from passive activities are generally limited to the tax allocable to those passive activities.

To be considered non-passive, a taxpayer must meet the material participation rules or the significant participation *rules*. A *taxpayer* shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Material and significant participation is determined by the following criteria:

(1) The individual must participate in the activity for more than 500 hours during the

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals for such year or

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual for such year or

(4) The activity is a significant participation activity (the activity is a trade or business and the individual participates more than 100 hours but less than 500 hours) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hour or

(5) The individual materially participated in the activity for any five taxable years, during the ten taxable years that immediately precede the taxable year or

(6) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Rev. Proc 2001-28 Guidelines that IRS uses to determine whether transactions are leases for federal income tax purposes.

Under a true lease, the lessor must retain a significant interest in the leased property at the end of the term; that is, the property must have a significant residual value and remaining useful life. If the lease term exhausts the useful life of the leased property, the transaction will be treated as a conditional sale or loan.

Code Section 39(a)(1)

Unused business credits can be carried back one year and forward twenty years.

Application of the Law

Lease equipment to a corporation for 6 years.

IAS has estimated and will obtain verification from an independent appraisal that the useful life of the solar lens is approximately 15 years and the solar panels are 30 years. The capital lease rules (lease term greater than or equal to 80% of the useful life of the equipment) would require IAS to treat a lease of 12 years or more for the solar lens and 24 years for the solar panels as a capital lease; which requires the transaction *be* treated as a sale. IAS would recognize the full gain on the sale of the equipment in the first year, if the leases are capital leases. A six year lease of the equipment is less than the 80% useful life and would be treated as an operating lease rather than a deemed sale. The lease payments would be recognized as income in the year they are received.

Code section 48(d) discusses leases that are to be treated as short term leases. A short term lease would only allow the lessee to take a partial credit. One of the four criteria to be considered a short term lease is, the class life is in excess of 14 years. Section 168(e)(3)(B)(vi) clearly establishes solar equipment to have a class life from 4 to 10 years. Therefore, the solar equipment lease would not be subject to the special short term lease rule and the lessee would be able to take the full 30% or \$9,000 tax credit, according with the general rule.

IAS could depreciate the actual cost of the leased equipment over the applicable MACRS life and not have to reduce the basis by 50% of the credit, as per code section 50. Under Reg I.48-4(n) the lessee will be required to take into income a portion of the tax credit over a period of 5 years. The amount required to be added to income by the see is 50% of the tax credit (\$4,500) divided by 5 (the shortest recovery period allowed), or \$900 per year.

The payment up front of \$9,000 by the lessee for the first 6 years lease payments would be a payment of prepaid rent and would have to ^amortized by the lessee over

t six years of the lease. IAS would have to recognize the payment as income in the year it receives it.

IAS would own the leased property at the end of the lease and could purchase the portion of the plant that has not been leased, at fair market value

The passive activity rules do not apply to the C-corporation.

2. Lease equipment to an LLC.

The same rules and issues for leasing to the corporation would apply to leases with an LLC.

Additional issues:

In order for the non-corporate lessor to be entitled to the credit, the lease term must be less than one half the useful life of the asset and for the first 12 months after the property is transferred to the lessee the ordinary deductions allowed to the lessor with respect to the lease, must exceed 15% of the rental income produced by the property. Six years is less than one half of the useful life of the equipment.

It is represented that for the first 12 months after the property is transferred to the lessee, the code section 162 deductions allowed to the lessor with respect to the property will exceed 15% of the rental income produced by the property.

Members of the LLC will have to apply the passive activity rules to the income or loss passed through to them as well as the tax credits passed through. To fully take advantage of any losses and the tax credits passed through, they will need to have passive income or meet the material participation rules enumerated in the Code Section 469 narrative above.

3. IAS builds its own plant.

The Company would be able to depreciate the plant at cost basis not fair market value. They would be able to take the energy credit used on the cost basis of the plant.

This advice is not intended or written by Hansen, Barnett & Maxwell to be used and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

**This advice has been written to support IAS in the promotion or marketing of the transactions addressed by this written advice.
Any taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor before relying on this advice letter,**

Hansen, Barnett &. Maxwell

