

New Treasury Guidance Explains Methodologies For Cost-Basis Analysis

A recent paper describes how the Treasury evaluates costs for solar projects when administering Section 1603 grants.

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Editor's note: As the Treasury's Section 1603 cash-grant program winds down, it continues to generate a great deal of interest and questions. In response, Solar Industry is presenting an insider's look at the Treasury's administration of the 1603 grants. This article is the first in a special two-part series.

Solar market participants that seek to obtain Section 1603 cash grants from the U.S. Department of the Treasury frequently face three major questions: What is a reasonable markup on a solar PV property? How much can the purchaser-lessor pay for a solar facility in a sale-leaseback? What is the deemed purchase price in the case of a pass-through lease?

Fortunately, the Treasury has recently provided the industry with some answers to these questions. On June 30, the Treasury released a paper to assist applicants in determining their cost basis for certain solar PV properties for the purposes of the Section 1603 grant.

The paper states that applications will be evaluated to determine whether the basis of solar PV property includes only eligible items and whether the basis represents the applicant's actual costs or, in certain cases, the fair

market value of the eligible property.

This information is relevant to all current applicants, as well as to any applicants who begin construction on a project and then complete it by the end of 2016. It also may be useful for the investment tax credit, because the grant follows the same basic principles as the tax credit.

The Section 1603 grant program was created by the American Recovery and Reinvestment Act of 2009 (ARRA) as a way to stimulate investment in energy properties (including solar properties) by reimbursing an applicant for a portion of the cost of the specified energy property. In the case of solar property, the grant is paid in lieu of the federal investment tax credit.

To qualify for a grant, a solar property must be placed in service during 2009, 2010 or 2011, or by the end of 2016 if construction of the solar property began during 2009, 2010 or 2011.

If the value of the grants paid by the Treasury is any indication, the grant program has been a huge success: Through June 2011, the Treasury received approximately 3,100 applications and paid nearly \$7.8 billion in grants; nearly 2,700 of the applications were for solar property, resulting in \$1.2 billion in grants.

The statutory language of Section 1603 mandates that the Treasury De-

partment shall pay the Section 1603 grants, and ARRA provides appropriations in the amounts necessary to carry out the program. Indeed, in a 2011 case, the U.S. Court of Federal Claims concluded that "Section 1603 compels the payment of money by the government and does not provide the government with any discretion to refuse such payments when the specific requirements of the statute are met."



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In considering the statutory requirements, the court instructed that the government must determine that the property qualifies as "specified energy property" that was placed in service during the relevant time period.

Although the Treasury does not have discretion to deny valid applications, the court indicated that the Treasury has the authority to determine whether "an applicant has miscalculated or misrepresented the basis of its property." This means that the Treasury can determine the proper basis upon which a grant will be paid.

The paper indicates that the Treasury review team will evaluate the basis using principles that are "consistent with tax concepts used to determine the basis for federal tax purposes." In this regard, the paper notes that it was jointly developed by two offices within the Treasury Department: the Office of the Fiscal Assistant Secretary, which manages and oversees the grant program, and the Office of Tax Policy, which develops and implements tax policy.

The basis is generally the cost of the property and may include other costs relating to the acquisition or construction of the property that are capitalized for tax purposes. For example, costs for obtaining permits

Figure 1: Cost Analysis of Solar Energy Systems

Residential	Residential/Small Commercial	Commercial	Large Commercial/	Utility
Size Range	< 10 kW	10 kW - 100 kW	100 kW - 1,000 kW	> 1 MW
Typical Size	5 kW	25 kW	250 kW	2 MW
Turnkey Price per Watt	+/- \$7	+/- \$6	+/- \$5	+/- \$4

Source: Mayer Brown

and engineering services for a solar project may be capitalized into basis, and interest during construction may be capitalized into basis in limited circumstances.

The paper quotes *Bryant v. Commissioner*, 790 F.2d 1463 (9th Cir. 1986), for the proposition that “in certain circumstances, a taxpayer’s stated cost for an asset does not reflect the true economic cost of that asset to the taxpayer and will be ignored for the purposes of determining the basis of the asset.”

In the *Bryant* case, the taxpayers bought beavers for investment in exchange for cash and promissory notes that could be repaid by returning some of the beavers. The taxpayers had an incentive to pay inflated prices for the beavers to obtain larger tax depreciation deductions and investment tax credits. The court determined that, because of peculiar circumstances involved in the purchases, the taxpayers’ basis should be limited to the fair market value of the beavers.

The paper also cites *Lemmen v. Commissioner*, 77 T.C. 1326, 1348 (1981), for examples of two situations in which the stated cost of an asset may be inconsistent with the asset’s true basis: “where a transaction is not conducted at arm’s-length by two economically self-interested parties or where a transaction is based upon ‘peculiar circumstances’ which influence the purchase to agree to a price in excess of the property’s fair market value.”

In the *Lemmen* case, the taxpayer invested in a cattle-breeding operation by purchasing two herds of cattle and executing contracts for maintenance services in exchange for cash and a promissory note. The court

found that the taxpayer was not motivated primarily by the tax advantages and rejected the government’s claim that the investment did not have a profit motive.

However, the court concluded that the portion of the taxpayer’s purchase price that exceeded the fair market value of the cattle was attributable to the maintenance contracts. The court stated that, “in purchasing a ‘package’ comprising cattle and a maintenance contract, the taxpayer had an obvious incentive to agree to an inflated purchase price for the cattle (at the expense of what otherwise may be treated as prepaid maintenance) so as to increase the investment tax credit and deductions for accelerated depreciation to which he would be entitled.”

Armed with these tax principles, in the case of solar properties, the Treasury will exercise increased scrutiny of the claimed basis in cases involving related parties, related transactions or other unusual circumstances to ensure that the claimed basis is consistent with fair market value.

As a first step, the Treasury will compare the claimed basis to certain benchmarks, which are predicated upon open-market, arm’s-length transactions between unrelated parties. The benchmarks will be updated as warranted, based on information from public and confidential sources and expert analysis.

The benchmarks, which include a profit, reflect a high quality of equipment installed by reputable companies across the U.S. The assigned review team understands that each solar PV system is different and that cost may be affected by the technology used, the system’s size and regional market differences.

The benchmarks for the solar PV market (as of the first quarter of this year) are shown in Figure 1.

If the applicant’s claimed basis is consistent with these benchmarks, the review team will evaluate the line items provided in the detailed cost breakdown to ensure that only eligible items are included. The basis will be accepted if there are no ineligible items, the claimed basis reflects only items appropriately attributable to the eligible property and there is adequate documentation to support the costs.

If the claimed basis is materially higher than the benchmarks, the review team will exercise closer scrutiny (especially where unusual circumstances are present) to determine whether only eligible costs are included, the applicant’s cost allocation between eligible and ineligible property is appropriate and the claimed basis is consistent with the property’s fair market value.

The review team may ask an applicant to submit a more detailed cost breakdown showing equipment costs and any markups. In addition, the applicant may choose to submit a detailed and credible third-party appraisal to support its claimed basis. Finally, the Treasury may adjust the basis to a level it believes reflects the actual cost.

Through express statements, as well as the examples and cases cited, the paper makes it clear that “fair market value” plays an important role in determining the proper cost basis. Fair market value is the “price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.”

In determining fair market value, the review team will evaluate those appraisals provided by the applicant that are prepared by independent, certified appraisers with expertise in solar PV properties. The paper describes three broad methods used in such valuation efforts.

The first and most preferred method is the cost approach, which is based on the actual cost to build the property. This method should clearly show the cost buildup, including hard costs, soft costs and profit. The review team will accept a cost approach that includes only eligible property, a markup that is consistent with industry standards, and the scope of work for which the markup is received. Although an appropriate markup is case-specific, and may vary based on the activity, capital investment and risk, the paper indicates that an appropriate markup will typically fall between 10% and 20%.

The second method is the market approach, which is based on comparable sales. Although market data are readily available, the paper cautions that the prices of comparables must reflect only the value of eligible property.

The third method is the income approach, which is based on the discounted value of future cashflow. This is considered the least reliable method. The assumptions used in an appraisal should be well-reasoned, sufficiently documented and based on market expectations.

According to the paper, if the income approach yields a project valuation that significantly exceeds the cost to build the project, this will raise a question about whether a portion of the value should be allocated to other ineligible assets, rights or contracts associated with the project. In this regard, the Lemmen case described above is instructive.

If the Treasury denies or reduces the amount of a grant, that decision is final and not appealable. However, if the review team adjusts the basis downward with respect to an application where a grant is approved, the applicant may contact the Treasury to ask questions using the contact information provided in the award letter. Notwithstanding this informal opportunity to ask questions (and make a case in support of the claimed amount), an applicant's only formal remedy is to sue in the U.S. Court of Federal Claims, as the applicants did in the ARRA Energy I case.

The paper provides guidance for applicants in a number of common situations. The owner-applicant may have purchased a solar facility from the developer and then leased it back to the developer in a sale-leaseback transaction. If there is a large prepayment of rent that effectively offsets a portion of the purchase price, the owner-applicant/lessor may have an incentive to pay an inflated purchase price to the developer in order to claim a higher cost basis and apply for a larger grant.

However, if the purchase price exceeds the applicable benchmark and does not represent fair market value for the facility, the review team may reduce the claimed basis to what it determines to be the fair market value.

The owner-applicant may have acquired a solar facility from an affiliated developer for the developer's actual cost plus a markup. Because the owner and the developer are affiliated, there

may be an incentive for the owner to pay an inflated purchase price so that it can claim a higher cost basis and apply for a larger grant. In this situation, the review team may reduce the claimed basis to reflect a reasonable markup.

The owner-applicant may have acquired a solar facility subject to a power purchase agreement (PPA). If the PPA has favorable pricing, some portion of the purchase price may be attributable to the PPA (which is not eligible for a grant) instead of the solar PV property.

In this situation, the review team may reduce the claimed basis to reflect only the portion of the purchase price that is properly attributable to the eligible property. A similar reduction may occur where a portion of the cost for equipment is attributable to a long-term warranty.

In the case of the so-called "pass-through" lease, where the lessor of a facility passes the grant through to the lessee, the amount of the grant is based on the facility's fair market value, rather than on its cost or purchase price. Nevertheless, the cost of the facility may be useful in supporting an appraisal to substantiate the claimed grant amount, especially where the fair market value exceeds the applicable benchmark. ☞

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