

## US Treasury Department Issues Guidance on Energy Grants In Lieu of Tax Credits

On July 9, 2009, the US Treasury Department (Treasury) issued long-awaited guidance on grants in lieu of tax credits (Grants) under section 1603 of the American Recovery and Reinvestment Act of 2009 (section 1603). The Treasury guidance includes three key documents: (i) Program Guidance, (ii) Sample Application, and (iii) Terms and Conditions. These documents can be found on the Treasury's web site at: <http://www.treasury.gov/recovery/1603.shtml>.

Section 1603 established a program whereby an eligible person could, in lieu of claiming the production tax credit under Internal Revenue Code (the Code) Section 45 or the investment tax credit under Code Section 48, apply to Treasury for a Grant with respect to "specified energy property" to provide a reimbursement for a portion of the costs of such property. The term "specified energy property" includes facilities that produce electricity from certain renewable resources, including wind, solar, fuel cells, closed-loop biomass, open-loop biomass, geothermal, landfill gas, trash, qualified hydropower, and marine and hydrokinetic renewable energy. Depending on the renewable resource, the Grant generally will equal either 30 percent or 10 percent of the basis of the property. *Observation:* The Grant is economically equivalent to the monetization of the investment tax credit under Code Section 48, which may be elected as an alternative to the production tax credit under Code Section 45.

### Program Guidance

#### APPLICATION PROCEDURES

For property placed in service in 2009 or 2010, the Grant application must be submitted after the property has been placed in service. For property not placed in service in 2009 or 2010, but for which construction began in 2009 or 2010, the application must be

submitted after construction commences. In either case, the application must be submitted before the statutory deadline of October 1, 2011. For a brief summary of the information requirements of the application, see the discussion below under "Sample Application." Applicants must register with the Central Contractor Registration (CCR), and payments will be made by Electronic Funds Transfer based on the banking information in the CCR.

When Treasury determines that an application is approved, a notice is sent to the applicant and the Grant will be paid no later than five days after the notice. If an applicant has not submitted enough information for Treasury to make a determination, the applicant will be notified and given 21 days to submit additional information. If Treasury determines that an application does not qualify for a Grant, the applicant will be notified of the reasons and the notice will be considered the final agency action on the application.

Treasury will make a Grant payment to an approved applicant within 60 days of receiving a completed application.

#### NON-TAXPAYER PROHIBITION AND FOREIGN PERSONS

Under section 1603, the following persons are not eligible to receive Grants: (i) the Federal or any state or local government (or any political subdivision, agency, or instrumentality thereof); (ii) any organization described in Code Section 501(c) and exempt from tax under Code Section 501(a); (iii) any clean renewable energy bond lender, cooperative electric company, or governmental body; or (iv) any partnership, or other pass-through entity, that has as a partner (or other holder of an equity or profits interest therein) one of the entities described in (i)-(iii) (Ineligible Entities).

In the case of an applicant that is a partnership or other pass-thru entity, no direct or indirect partner or similar interest holder can be an Ineligible Entity. However, the fact that a partnership-applicant has a taxable C corporation as a direct or indirect partner, which corporation in turn has Ineligible Entities as direct or indirect owners, does not affect the eligibility of the partnership for Grants. *Observation:* If the applicant itself is a taxable C corporation, the presence of Ineligible Entities as direct or indirect shareholders should not affect the eligibility of the corporation for Grants. Thus, it is possible for a person who otherwise would not be eligible to receive a Grant to set up a so-called “blocker” corporation to hold its interest.

A foreign person or entity may be eligible for a Grant with respect to property if the person or entity qualifies for the exception in Code Section 168(h)(2)(B), which generally applies where more than 50 percent of the gross income from the property is subject to US federal income tax. *Observation:* The Program Guidance does not address the situation where the applicant is a partnership in which a foreign person or entity is a partner. It appears that the presence of a foreign partner will not affect the applicant’s eligibility regardless of whether a so-called “blocker” corporation is used.

Applicant eligibility will be determined at the time the application is received. *Observation:* Because eligibility is determined when the application is received, an applicant that might have been ineligible when a facility was placed in service can restructure its ownership to ensure eligibility at the time of the application.

#### BEGINNING OF CONSTRUCTION AND PLACED-IN-SERVICE DATE

To be eligible for a Grant, specified energy property must be originally placed in service during 2009 or 2010, or after 2010 if construction begins during 2009 or 2010 and the property is placed in service by the credit termination date (which ranges from January 1, 2013, to January 1, 2017, depending on the type of property involved). The Program Guidance provides that construction is considered to commence when “physical work of a significant nature begins,” and the guidance elaborates on when physical work begins for both self-constructed property and for property constructed by contract. Under a safe harbor, an applicant may treat physical work of a significant

nature as beginning when the applicant incurs more than 5 percent of the total cost of the property (subject to certain exclusions).

Property is placed in service when it is ready and available for its specific use. *Observation:* This standard is essentially the same as the existing law standard for purposes of depreciation deductions, investment tax credits and production tax credits.

#### UNITS OF PROPERTY

All components of a larger property are treated as a single unit for purposes of determining the construction commencement date and the placed-in-service date if the components are functionally interdependent: the placing in service one component is dependent on the placing in service of the other component. For example, a wind turbine, its tower, and its supporting pad constitute a single unit of property, but the computer control system for a wind farm is a unit of property that is separate from the wind turbines.

Where the property in question consists of multiple units of property that are located at the same site and that will be operated as a larger unit, the applicant may elect to treat the units as a single unit of property for purposes of determining the beginning of construction and the placed-in-service date. For example, the owner of a wind farm may treat as a single unit of property a wind farm, including all turbines, their towers and supporting pads, the computer control system, and associated power condition equipment. *Observation:* This is a favorable rule that will allow an applicant to group a number of facilities that are part of single project in one application. It also may allow an entire project to qualify for a Grant even though construction on some facilities in the project may not have commenced by the placed-in-service deadline.

#### ORIGINAL USE

Under the Program Guidance, the applicant “must have originally placed the property in service.” *Observation:* Although the “original” requirement is not expressly required by section 1603, the addition of such a requirement is reasonable and seems to be consistent with the objectives and policy of section 1603.

If a facility contains used parts, in order to satisfy the “original” requirement, the cost of the used parts

cannot exceed 20 percent of the total cost of the facility. *Observation:* This standard is essentially the same as the so-called “80-20 rule” under existing law.

If property is originally placed in service, sold to the applicant, and then leased back by the applicant to seller, all within three months of the original placed-in-service date, unless the lessor and lessee elect otherwise, the applicant-lessor is considered the original user of the property and the property is considered placed in service not earlier than when it is used under the leaseback. *Observation:* This three-month exception may allow a project that was placed in service in late 2008 but leased under a sale-leaseback in early 2009 to qualify for a Grant.

#### TYPES OF PROPERTY AND REQUIRED DOCUMENTATION

The Program Guidance details the types of “specified energy property” that are eligible for Grants and the supporting documentation that must be provided for each type of specified energy property to demonstrate that the property is eligible and has been placed in service.

Only the portion of a facility that is described in Code Section 48 is taken into account in computing the amount of a Grant. For example, only solar property qualifies for a Grant, not the building upon which the solar property is installed. Property is ineligible for a Grant when it is predominately used outside the United States – i.e., when the property is located outside the United States for more than 50 percent of the year.

#### ELIGIBLE BASIS

For purposes of determining the amount of a Grant, the property’s basis is determined in accordance with the general rules applicable for US federal income tax purposes. This means that the basis generally is the cost of such property, including “all items properly included by the taxpayer in the depreciable basis of property, such as installation costs and the cost for freight incurred in construction of the specified energy property.” *Observation:* This rule allows the inclusion of all costs that are properly capitalized into the basis of the property, presumably including an allocable portion of certain soft costs such as a development fee.

However, costs that will be deducted for federal income tax purposes in the year the specified energy property is placed in service, such as Code Section 179 expenses, are not included in the basis for purposes of calculating the amount of a Grant. *Observation:* This limitation does not apply to costs that will be recovered through depreciation or amortization deductions (including any bonus depreciation).

The Program Guidance specifies that applicants must submit with their application documentation to support the cost basis claimed. For properties that have a cost in excess of \$500,000, applicants must submit an independent accountant’s certification attesting to the accuracy of all costs claimed as part of the property’s basis.

#### LEASED PROPERTY

Lessors who are eligible to receive Grants may irrevocably elect to pass-through Grant payments to a lessee. Under this election, the lessee is treated as having acquired the property for its fair market value on the transfer date. *Observation:* Because the sale price is often higher than the cost of construction, this rule will allow a higher Grant amount to be claimed. In order to make the election, (i) the lessor and lessee must agree that the lessor waives all rights to Grant payments and production tax credits or investment tax credits; (ii) the lessee must agree to include in gross income over the five-year recapture period an amount equal to 50 percent of the Grant payment; (iii) the lessor and lessee must both be persons eligible to receive a Grant; and (iv) the lessor must not be a mutual savings bank, regulated investment company, or real estate investment trust.

In the case of a sale-leaseback transaction, the following additional requirements must also be met: (i) the lessee must have originally placed in service the property; (ii) the property must be sold and leased back by the lessee within three months after the date the property was originally placed in service; and (iii) the lessee and lessor must not make an election to preclude application of the sale-leaseback rules. Elections are made with respect to each property leased by executing a written agreement containing the information specified in the Program Guidance.

## RECAPTURE AND GRANT REPAYMENTS

When property for which a Grant is paid either is disposed of to an Ineligible Entity or ceases to qualify as specified energy property within five years of the placed-in-service date (each, a Disqualifying Event), some or all of the Grant must be repaid.

*Observation:* The recapture triggers are significantly narrower than those that apply to the investment tax credit. For example, a sale by a partner of its partnership interest to an entity that is not an Ineligible Entity will not trigger a recapture of the Grant, such that an equity investor could be brought in after the placed-in-service date. This will make equity investments in projects taking the Grant more liquid and mitigate lender risk relating to potential recapture claims.

If the Disqualifying Event occurs in (i) the first year, 100 percent must be repaid; (ii) the second year, 80 percent must be repaid; (iii) the third year, 60 percent must be repaid; (iv) the fourth year, 40 percent must be repaid; and (v) the fifth year, 20 percent must be repaid. Selling property to an entity other than an Ineligible Entity does not result in recapture provided the property continues to qualify as a specified energy property and the purchaser of the property agrees to be jointly liable with the applicant for any recapture.

*Observation:* Presumably, such an agreement must be between the applicant and a purchaser of the property and not Treasury.

The receipt of a Grant does not create lien on the property in favor of the United States. Grant amounts that must be repaid can be collected by all available means against any assets of the applicant, but such amounts are not considered tax liabilities. *Observation:* Although not expressly stated, it appears that only the applicant (and any purchaser that is jointly liable) will be liable for any recapture payment, and collection efforts presumably will not be made against the applicant's equity owners or lenders. The recapture rules are quite favorable and will avoid the complex inter-creditor agreements that otherwise might have been necessary between project developers and lenders.

## REITS

Real estate investment trusts (REITs) are eligible for limited Grants. The calculation compares the REIT's taxable income to its taxable income before taking

into account deductions for dividends paid.

*Observation:* Because REITs generally pay dividends equal to or in excess of their taxable income, unless modified, this limitation will, as a practical matter, preclude REITs from participating in the Grant program. The National Association of Real Estate Investment Trusts has submitted comments to Treasury to attempt to open the Grant program to REITs.

## MISCELLANEOUS

The Program Guidance also specifies that:

- Applicants may assign the Grant to a third party;
- Property does not become subject to the National Environmental Protection Act (NEPA) or the Davis-Bacon Act as a result of receipt of a Grant;
- Except for the income inclusion in the case of a pass-through lease, the Grant amount is not included in taxable income;
- The basis of property is reduced by 50 percent of the Grant payment (except in the case of a pass-through lease); and
- In the case of utilities, Grant payments must be normalized.

## Sample Application

Although not yet accepting applications for Grants, Treasury did release a Sample Application that will be the first of two parts of the application package. The second part will be a signed copy of the Terms and Conditions, which are described below. The actual application, which may be submitted via a web-based application designed to expedite program implementation, will require the applicant to check boxes and provide additional information that will enable Treasury to determine Grant eligibility. Based on the Sample Application, it will have seven sections that will require the applicant to provide the following information:

- 1) Applicant's entity type (e.g., governmental entity, tax-exempt entity, partnership, corporation) and applicant's interest in the property (i.e., owner or lessee);
- 2) Information on the property, including whether the property is depreciable, where the property is located, and when the property was placed-in-service (or if not yet placed-in-service, when construction began);

- 3) Applicant information, including name, address, employer identification number, Data Universal Numbering System number from Dun and Bradstreet, and contact person;
- 4) Property description, including the type of specified energy property (e.g., wind, geothermal, solar), the purchaser of the energy or how the energy will be used, the nameplate capacity and estimated annual production, and the number of jobs created or retained (both in the construction and operational phases);
- 5) The cost basis of the property, whether it is eligible for a 30 percent or 10 percent Grant, and the amount of Grant requested;
- 6) Information supporting the placed-in-service status claimed in section 2, demonstrating that the property is a type of specified energy property as indicated in section 4, and supporting the costs claim in section 5; and
- 7) Signature of the applicant, including a declaration under penalties of perjury.

## Terms and Conditions

As noted above, the second part of the application package is a set of Terms and Conditions, which must be signed under penalties of perjury. The terms and

conditions include a statement that the applicant is eligible to receive a Grant, as well as an ongoing obligation to inform Treasury if any information in the application is inaccurate or incorrect. The applicant must agree that no tax credit under Code Section 45 or 48 will be claimed for the Grant property. In addition, the applicant must agree to provide project performance reports for five years and maintain project, financial, and accounting records to demonstrate eligibility.

Treasury will post a notice with further instructions when it is ready to begin receiving applications. We expect that Treasury will be ready to receive applications on or around August 1, 2009.

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*For more information about guidance, the Grants, or any other matter raised in this Client Update, please contact any of the following lawyers.*

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