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Legal Update
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# US Treasury Issues Additional Guidance on Beginning of Construction for Section 1603 Cash Grant Program

On June 25, 2010, the US Department of the Treasury (Treasury) released additional guidance for the Section 1603 cash grant program. The guidance is in the form of frequently asked questions and answers (FAQ) addressing the "beginning of construction" requirement for renewable energy property placed in service after 2010 but before the applicable placed-in-service deadline.

## Background

The cash grant program was enacted by Section 1603 of the American Recovery and Reinvestment Act of 2009. The program allows an eligible person to apply to Treasury for a grant with respect to certain renewable energy property in lieu of claiming the production tax credit under Internal Revenue Code Section 45 or the investment tax credit under Internal Revenue Code Section 48. In order for renewable energy property to qualify for a grant under Section 1603, it must have been placed in service in 2009 or in 2010, or construction must have begun by the end of 2010. On March 15, 2010, Treasury revised the Program Guidance to change the rules regarding the beginning of construction. The changes are described in a prior Legal Update which is available here http://www.mayerbrown.com/projects/article.asp?id=8723&nid=9586. The FAQ, which is available here http://www.ustreas.gov/recovery/docs/FAQs%20for%20Beginning%20of%20Construction.finalweb.doc, clarifies and elaborates on the revised Program Guidance, which is available here http://www.ustreas.gov/recovery/docs/guidance.pdf.

## Two Tests

The FAQ confirms that there are two ways to show that construction has begun: either begin "physical work of a significant nature," or meet the safe harbor provided where an applicant pays or incurs 5 percent of the total cost of the specified energy property. The FAQ explains what is required by the physical work test and how the 5 percent safe harbor is met. The standard for the safe harbor is described as "more than 5%" by the revised Program Guidance and as "5.00% or more" by the FAQ. While there is little practical difference between the two standards, a Treasury official has suggested that applicants can rely on the more generous standard in the newer FAQ (5 percent or more), even though the Program Guidance is more formal.

## Physical Work of a Significant Nature

The FAQ confirms that *any* physical work *on the specified energy property* may qualify as the beginning of construction, but the FAQ places some limitations on this. The specified energy property is limited to tangible personal property and other tangible property used as

an "integral part" of the activity performed by the qualified facility and located at the site of the qualified facility. In this regard, the FAQ confirms that a step-up transformer may qualify as specified energy property and that work on a step-up transformer may count as physical work. This could be important for a wind project in which work can begin on a step-up transformer before permits are secured to begin work on roads or turbine foundation pads. In contrast, transmission property does not qualify as specified energy property.

One limitation of particular interest is the requirement regarding continuous activity. The FAQ states: "Treasury will closely scrutinize any construction activity that does not involve a continuous program of construction or a contractual obligation to undertake and complete within a reasonable time, a continuous program of construction. Disruptions in the work schedule that are beyond the applicant's control (for example, unusual weather or a site at which work can only be performed during certain seasons) will be taken into account in determining whether or not an applicant has undertaken a continuous program of construction." This rule is intended to prevent a developer from starting physical work (*e.g.*, by pouring a single turbine foundation pad) merely to qualify a project for a grant, and then ceasing activity for an extended period. However, the FAQ does not indicate how much activity is necessary for it to be considered continuous. A similar requirement does not apply to the 5 percent safe harbor, which is described below.

The FAQ reiterates the distinction drawn in prior guidance between roads that are integral to the qualified facility (such as roads for moving materials to be processed and roads for equipment to operate and maintain the qualified facility) and roads that are not integral to the qualified facility (such as site access roads and roads used solely for employee or visitor vehicles). The FAQ confirms that preliminary work, such as clearing land, obtaining permits, putting up fencing or removing existing facilities to prepare a site, is not physical work on the specified energy property. In addition, constructing a building that will be used for operations and maintenance is not physical work of a significant nature.

The FAQ also confirms that *any* physical work performed under a binding written contract may be taken into account, but only if the work takes place *after* the binding written contract is entered into and if the work will become specified energy property of the applicant. A contractor may use any reasonable, consistent method to allocate work it performs for a number of customers among those customers. The FAQ provides that work performed under a contract does not include work to produce components or parts that are in existing inventory or are normally held in inventory by a manufacturer. A Treasury official indicated that this rule essentially creates a presumption that work on off-the-shelf property can not be taken into account unless it can be proven that the work actually occurred after the binding written contract was entered into, which is consistent with the grant program's policy objective of stimulating economic activity.

## 5 Percent Safe Harbor

The FAQ confirms that the "economic performance" rules of Internal Revenue Code Section 461(h) continue to apply for determining when a cost is paid or incurred for purposes of the 5 percent safe harbor, notwithstanding that the specific reference to such rules was deleted in the revised Program Guidance. Accordingly, costs are taken into account when cash-method taxpayers "pay" them and when accrual-method taxpayers "incur" them. The FAQ states that costs are "incurred" when (i) the fact of the liability is fixed, (ii) the amount of the liability is determinable with reasonable accuracy and

(iii) the economic performance test described in Treasury Regulation Section 1.461-4 has been met with respect to such costs.

The FAQ indicates that the economic performance test is satisfied when property is provided to the applicant. Depending on the applicant's method of accounting, property is treated as provided either when title to the property passes to the applicant, or when it is delivered to or accepted by the applicant. A Treasury official has confirmed that the "applicant's method of accounting" refers to the method of determining when the property is provided, and that this method must be used consistently from year to year.

Thus, property does not need to be delivered for the cost of such property to count toward the 5 percent safe harbor. However, the FAQ provides that merely paying for property is not sufficient unless the applicant reasonably expects that the property will be delivered within three and one-half months of the date of payment, in which case it will be considered to have been provided on the payment date. It is noteworthy that the period of three and one-half months is measured from the date of payment rather than December 31, 2010 (unless the payment is made on December 31, 2010). A Treasury official said that Treasury considered allowing until April 15, 2011 in all cases, but decided to give deference to existing rules rather than further extend an already generous exception to the requirement that property be delivered.

With respect to the so-called "look-through rule," which is an exception to the economic performance test, costs paid or incurred by a person providing property to the applicant are treated as being paid or incurred by the applicant, even if the property has not been delivered to the applicant. The look-through rule does not apply twice to allow the applicant to be treated as having paid or incurred costs that have been paid or incurred by a subcontractor (*e.g.*, a contractor's supplier). In other words, only costs paid or incurred by contractors or suppliers that have contracts directly with the applicant are taken into account for purposes of the 5 percent safe harbor. An applicant may rely on a statement by a supplier as to the amount of costs incurred by the supplier with respect to the property to be manufactured, constructed or produced for the applicant under a binding written contract.

The FAQ also provides some guidance on master (or frame) agreements, stating that costs incurred under such agreements can be allocated to special purpose vehicles that acquire property under these agreements. This long-awaited guidance is useful for developers that utilize master agreements and that will incur costs under the master agreement in 2009 or 2010 but will not allocate the costs and related property to a specific project until a later date.

The FAQ also confirms that the 5 percent safe harbor is measured by reference to the actual costs of the property, not the budgeted costs of the property. This distinction will be of particular importance in the case of cost overruns, and it increases the importance of controlling the costs. In the event of cost overruns, it may be advantageous to redefine the qualified facility (*e.g.*, by disaggregating units of property at a site) in order to qualify a smaller facility for a grant, and the FAQ sanctions this approach. In addition, if an applicant satisfies the 5 percent safe harbor as of December 31, 2010, the applicant does not need to continue work at the site in 2011 in order to qualify for a grant in 2012.

## Process and Documentation

The FAQ provides that for projects placed in service after 2010, but before the statutory deadline of October 1, 2011, applicants need to submit only a single application demonstrating that construction on the property began in 2009 or 2010 and that the property has been placed in service. For projects that will be

placed in service after October 1, 2011, applicants need to submit a preliminary application by October 1, 2011, demonstrating that construction on the property began in 2009 or 2010, and supplement that application when the property is placed in service.

The FAQ discusses some of the documentation that will be required to demonstrate that construction has begun. The applicant must submit statements, signed under penalties of perjury, describing the project's eligibility for a grant. To meet the "physical work of a significant nature" requirement, the statement should include the construction schedule for the project, its budget and a description of the work that has been performed. To meet the 5 percent safe harbor, the statement should include (i) a description of the costs paid or incurred, (ii) an estimate of the total costs of the project and (iii) invoices or other evidence that the costs have been paid or incurred.

*For more information about the matters raised in this Legal Update, please contact your regular Mayer Brown contact or the attorney listed below.*

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