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Legal Update
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US Treasury Provides Guidance on Change in Ownership for Section 1603 Cash Grant Program's 5% Safe Harbor

On December 12, 2011, the US Department of the Treasury (Treasury) posted additional guidance for the Section 1603 cash grant program in the form of an update to the frequently asked questions and answers (FAQ) that address the "beginning of construction" requirement for renewable energy property.

The update, which adds FAQ 23 and 24, provides guidance regarding the application of the 5% safe harbor where there has been a change in ownership of either the energy property or the entity that satisfied the 5% safe harbor. Presumably, the guidance is intended to allow a transfer of energy property that legitimately is part of a project (albeit a project that is under development), while preventing trafficking of naked assets that satisfy the 5% safe harbor.

Background

The 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 projects in lieu of claiming the production tax credit under Internal Revenue Code (IRC) Section 45, or the investment tax credit under IRC Section 48. If a renewable energy project has not been placed in service by the end of 2011, in order to qualify for a Section 1603 grant, the applicant must demonstrate that construction has begun in 2009, 2010 or 2011. There are two ways to show that construction has begun: either begin "physical work of a significant nature" or meet the "5% safe harbor" by paying or incurring 5% of the total cost of the specified energy property.

Our prior Legal Updates regarding the Program Guidance and the FAQ are available at http://www.mayerbrown.com/projects/article.asp?id=8723&nid=9586 and http://www.mayerbrown.com/publications/article.asp?id=9249&nid=6. The current FAQ regarding "Beginning of Construction," is available at http://www.treasury.gov/initiatives/recovery/Documents/K%20FAQs%20for%20Begun%20Construction.pdf. It clarifies and elaborates on the Program Guidance, which is available at http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20(2)%20clean.pdf.

FAQ 23—Changes in Ownership of Energy Property

FAQ 23 addresses the situation where ownership of energy property changes (whether by contribution, assignment, or other form of transfer) between the time the property is acquired for use in a project with the expectation that it satisfy the 5% safe harbor and the time the project is placed in service. FAQ 23 provides that, for purposes of the 5% safe harbor, the transferee of the property essentially may "step into the shoes" of the transferor with respect to the date the transferor acquired the property and the amount the transferor paid or incurred to acquire

the property, but only if (i) the transferee uses the property in the same project for which the transferor acquired it and (ii) the transferee is related to the transferor.

Presumably, by having the transferee essentially step into the shoes of the transferor, Treasury intended to preclude a mark-up on related party transfers that otherwise might allow a project with a higher cost to qualify by artificially increasing the costs that count toward the 5% safe harbor. The requirement that the transferee use the property in the same project for which the transferor acquired it likely was intended to prevent the trafficking of naked property that is not associated with a project, while preserving the flexibility implicitly afforded by FAQ 20 with respect to property acquired under a master contract that is later assigned to a specific project (which FAQ 23 now clarifies must be owned by a related person).

In order to qualify as related, the transferor and the transferee must be considered related persons within the meaning of IRC Section 197(f)(9)(C) either immediately before or immediately after the transfer of the property. In the case of a partnership, which is the most common situation in the financing of renewable energy projects by developers, this rule generally provides that a partner is related to a partnership if the partner owns, directly or indirectly, more than 20% of the capital or profits interest in the partnership. Given the thresholds for determining related party status, and the fact that FAQ 23 expressly states that the transferee is treated as having paid or incurred the costs that the transferor paid or incurred, there does not appear to be a requirement that the transfer be made in a tax-free exchange.

If the property is transferred to an unrelated person after December 31, 2011, the transferee may not take into account the costs that the transferor incurred with respect to the property in determining whether the 5% safe harbor is met. In other words, the transferee may not step into the shoes of the transferor for purposes of determining when the transferee acquired the property or how much the transferee paid for the property. Thus, the transferee will not be treated as acquiring the property by December 31, 2011. However, there is a narrow exception to this limitation in the case of a sale/leaseback arrangement, in which case the transferee will be treated as satisfying the 5% safe harbor if the property is transferred to an unrelated party and leased back to the transferor within 90 days of the placed-in-service date.

FAQ 24—Changes in Ownership of Entities that Own Energy Property

FAQ 24 addresses the situation where the ownership of an entity that owns energy property meeting the 5% safe harbor changes after December 31, 2011, but before the property is placed in service. In that situation, the eligibility of the entity (and the property) is not adversely affected (and they are essentially "grandfathered") if (i) the purchaser is an otherwise eligible Section 1603 applicant and (ii) the entity being sold has commenced development of the project as evidenced by activity such as acquiring land, obtaining permits and licenses, entering into a power purchase agreement, entering into an interconnection agreement, and contracting with an engineering, procurement and construction (EPC) contractor.

This "grandfather" rule does not apply to an entity that holds equipment only but has not commenced development. In such a case, a purchaser of that entity may not rely on the costs paid or incurred to acquire that equipment to satisfy the 5% safe harbor.

FAQ 24 provides the following example to illustrate both sides of this rule:

> A project company meets the 5% safe harbor and commences development by acquiring permits, a power purchase agreement and an interconnection agreement. A partnership interest in the project company is then sold to a tax equity investor (or the tax equity

investor makes a capital contribution in exchange for a partnership interest) in a partnership flip transaction. The project company (with the new tax equity investor as a partner) may rely on costs incurred by the project company to satisfy the 5% safe harbor. On the other hand, if a project company meets the safe harbor by purchasing and taking delivery of equipment but does no other activity, the purchaser of the project company may not rely on costs incurred by the project company to satisfy the 5% safe harbor.

By imposing the development requirement, Treasury apparently intended to provide a backstop to the rule regarding transfers of property. Thus, an enterprising person is not able to form a special purpose entity to acquire energy property with no intention of developing a project and then sell that entity (instead of the property) for a premium due to the property's potential eligibility for a Section 1603 grant. FAQ 24 does not specifically address the treatment of entities that are disregarded for tax purposes.

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

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