

TREASURY'S GUIDANCE FOR ITC GRANTS – SOME PRACTICAL CONSIDERATIONS

On July 9, 2009, the U.S. Treasury Department released Program Guidance (the "Guidance") that clarifies major aspects of the cash grant provisions enacted in Section 1603 of the American Recovery and Reinvestment Act that became law in February 2009. These provisions allow a renewable energy facility owner to receive a cash grant from the Treasury in lieu of claiming production or investment tax credits for certain projects placed in service in 2009 or future years. For additional background on the law relating to this cash grant program, and types of eligible renewable energy facilities, please [click here](#).

The Guidance (which can be found on the Department of the Treasury's website at (<http://www.treasury.gov/recovery/1603.shtml>)) generally covers the following issues: (1) application procedures; (2) applicant eligibility; (3) property eligibility; (4) determining the grant amount; (5) special rules for leased property; (6) grant recapture rules; and (7) certain miscellaneous provisions dealing with issues such as assignability of the grant, and the applicability of some other federal laws, such as Davis-Bacon prevailing wage rules. In addition, Treasury also released a sample application form and a "Terms and Conditions" document that will need to be signed and submitted with an application package. **A number of other commentators have produced summaries of the Guidance and we encourage you to read some of them. Rather than provide another summary, here we try to build on those general summaries and focus on some of the practical considerations that the Guidance raises.**

Application Procedures

On or about August 1, 2009, Treasury will begin accepting cash grant applications on its website, and a sample application is available online at this address: <http://www.treasury.gov/recovery/docs/Application.pdf>. Only projects that are either placed in service or on which construction begins in 2009 or 2010 will be eligible for the cash grant. There are different procedures for projects placed in service in 2009 or 2010 and for projects on which construction begins in 2009 or 2010 but that are not placed in service until a later year.

For projects placed in service in 2009 or 2010, applications must be submitted after the project has been placed in service but

The Rath, Young and Pignatelli Energy and Tax Practice Groups represent clients seeking to develop, operate, and invest in energy projects that qualify for federal tax benefits. For more information on the matters discussed in this Renewable Energy Update or other aspects of our practice, please contact:

- Curt Whittaker
(mcw@rathlaw.com)
- Chuck Willing
(cgw@rathlaw.com)
- Bill Ardinger
(wfa@rathlaw.com)
- Paul Burkett
(pab@rathlaw.com)
- Tony Sayess
(aks@rathlaw.com)

You may call us at (603) 226-2600 or visit us on the web at www.rathlaw.com.

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before October 1, 2011. An application package will include a signed and completed application form, Terms and Conditions form, payment information, and supporting documentation, including certain engineering reports, utility interconnection agreements (if applicable), cost documentation, and in some cases a cost certification from an independent accountant. Treasury expects to pay the cash grant within 60 days of receiving a completed application.

For projects which will not be placed in service before the end of 2010, applications may only be submitted after construction begins, but must be submitted before October 1, 2011. Treasury will review these applications and inform the applicant if supplemental information is needed before an eligibility determination can be made. Documentation will need to be provided demonstrating that construction has commenced, such as paid invoices, and if applicable, a binding construction contract. Once a project is completed, the applicant must submit additional proof that a facility has been placed in service before the grant will be paid.

Insights and Planning Tips

- **Certification.** The application certification appears to require that the signatory personally guarantee the accuracy of the submission (“to the best of my knowledge and belief”), which may be very troubling for a corporate officer or LLC managing member. Applicants should check their directors and officers insurance coverages, and executing officers would do well to get written confirmation from their employers that they will be indemnified for any personal complications associated with the filing.
- **Pre-Qualification.** The Guidance does not provide any real ability to fully pre-qualify a project in order to assure construction lenders that the grant absolutely will be there as part of a term loan package. Only facilities that will be completed after 2010 can submit an

interim application, and even then, no real assurances can be obtained regarding receipt of the cash grant until after a project’s completion. This may put a great deal of pressure on legal or consultant opinions to provide comfort to construction lenders, and it may cause term lenders to insist that term financing be delayed until receipt of the grant.

Applicant Eligibility

The statute authorizing the cash grant program provides that some persons are ineligible to receive the grant. These include government entities, 501(c) tax-exempt organizations, electric co-ops, and certain renewable energy bond lenders, as well as any tax partnership that has any of these ineligible persons as a direct or indirect partner. The Guidance clarifies that “C corporation” blocker entities can be used to prevent ineligible persons from being treated as directly or indirectly owning an interest in an entity that otherwise would be eligible to receive the cash grant. This clarification of the statute will be of great importance to private equity and hedge funds and should improve liquidity in the renewables sector.

Property Eligibility

Project eligibility depends on both the start of project construction, and the date the project is placed in service for tax purposes. The Guidance clarifies the standards used to determine these dates, and reminds owners that different types of project have different deadlines for completion.

First, a project that is placed in service in 2009 or 2010 is eligible to receive a grant, regardless of when construction on the project began. A project that will not be placed in service until after 2010 will only be eligible to receive a grant if construction begins on the project in 2009 or 2010.

As a general rule, a facility will be considered to be “placed in service” when all equipment has been installed, tested, and is ready and capable of being used for its intended purpose. There is a lot of

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history on the “placement in service” test, and project owners should understand that the general rule is a starting point for examining the specifics of their projects. This is especially true if the project has multiple independent generation units, such as a wind or solar array.

Construction is deemed to “begin” when non-preliminary work of a significant physical nature begins. The Guidance discusses different tests for “self construction” versus “construction by contract,” but in nearly all cases involving a project of any complexity, we must concentrate on the latter test, as nearly all larger scale projects involve a developer/owner contracting for components ahead of substantive site installation activities. Importantly, a safe harbor has been added to provide taxpayers with some level of certainty on this issue. The safe harbor treats construction as having begun when a facility owner pays (cash method taxpayers) or incurs (accrual method taxpayers) more than 5% of the total project cost (excluding costs related to land or preliminary activities).

“Units” of Property

The Guidance provides a considerable amount of flexibility regarding the classification of a “unit” of “property” for purposes of determining the beginning of construction and placement in service dates. The general rule is that all components that are “functionally interdependent” are treated as a single “unit” of property. For example, a wind turbine, tower, and pad form a single “unit.” However, if multiple “units” are located at one site (such as a wind farm), the owner can elect to treat all units at the site (and property that serves all or some of such units, such as a computer system), as a single “unit” for purposes of determining the beginning of construction and placement in service dates (including the 5% safe harbor test). The Guidance also provides that failure to complete the entire planned larger “unit” will not preclude receiving the cash

grant for the property that is placed in service by the credit termination date.

Insights and Planning Tips

- Commercial Operation. Treasury has really simplified the rule for commercial operation – if construction commences in 2009-2010, a project owner has until the relevant sunset date to achieve commercial operation.
- Binding Written Contract. A developer will commence project construction by entering into one or more “binding written contracts” under which the contractor has commenced physical work of a significant nature. A “binding written contract” must have a minimum 5% liquidated damages requirement. Some will remember this rule from the old Section 29 project rules.
- Marooned Components. The placement in service rules have a real downside for project components ordered before 2009. Those component orders, if they meet the binding written contract test, may have caused construction to begin on the project for which they are intended. Because construction thus commenced before 2009, the project must be placed in service before the end of 2010 to qualify for the ITC cash grant. This can be a real problem for components ordered for a project that has experienced delays.
- Halo Components. On the flip side of the marooned equipment issue, project developers apparently can place orders for a large amount of solar panels or wind turbine generators before the end of 2010, for delivery through the relevant credit termination dates. If all of the rules for binding written contracts or the safe harbor, above, are followed, “construction” will commence in 2010, grandfathering the intended projects for the ITC cash grant as long as construction is completed before the placement in service deadline. For that reason, it will be much better to order a

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qualifying component on or before December 31, 2010 than on or after January 1, 2011, and we expect a rising tide of equipment orders in the latter part of 2010 for precisely that reason.

- Safe Harbor. The safe harbor is generally very favorable, and, when combined with the “units” of property rule, may provide developers with significant benefits for projects that cannot be completed until after 2010 but for which the developer can make payments or incur costs in excess of 5% of the total project costs by the end of 2010.
- Cash vs. Accrual. Applicants relying on the safe harbor, especially accrual method taxpayers, should carefully review the rules for determining when project costs are paid or accrued. In general, costs are accrued as property is supplied or services are performed by a contractor, but there are limited exceptions for long-term contracts and prepayment of certain costs.

Open Issues

- Pre-Manufactured Components. How does a purchase of off-the-shelf, already manufactured components affect the commencement of construction? The most likely result is that a binding written contract for the purchase of a pre-made component triggers commencement of construction on that date if the cost of the component exceeds 5% of the total project cost, but the Guidance is not explicit on this point.
- Born Again Tax Basis. Can developers sell each other their pre-2009 components that were part of a binding written contract, and “marooned” as discussed above, and thereby establish a new post 1/1/2009 basis in the purchased components, and thus a new commencement of construction date? Even if the components they purchase are identical to ones they sell to other

developers seeking to establish their own new basis in components?

- Safe Harbor and Cost Increases. What happens if the 5% safe harbor for beginning construction is relied on, but subsequent cost overruns cause the prepayment to be less than 5% of the total project cost, as tested at the time the property is finally placed in service?

Original Use of Project Property

The Guidance provides that the original use of the property must begin with the applicant, but a couple of exceptions are provided. For example, the Guidance expressly incorporates the “80/20 rule,” a long standing rule that allows up to 20% of the total fair market value of the completed facility to be from used parts.

- 80/20 Test. This is very important in that it allows taxpayers to take advantage of existing equipment – and note that the test is relative market *value* of the used equipment as against the overall market value of the completed project. Repowering a dilapidated power plant that has a low commercial value may allow a developer to incorporate a relatively large amount of the existing equipment if the refurbished plant has a relatively high fair market value.
- Sale/Leaseback. The Guidance allows an owner of original use property to engage in a sale-leaseback transaction within 3 months after its placement in service date. In such a case, the lessor is eligible to apply for the cash grant, even though not the original user of the facility.

Determining What Property Comprises the “Facility”

The Guidance clarifies the scope of property that will comprise the “facility” for various types of renewable energy projects, and accordingly allows taxpayers to calculate the tax basis of the facility against which the cash grant will be paid. The Guidance is more liberal than some earlier rules, and

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while it clarifies this determination for some types of projects, it raises some questions for other types.

Insights and Planning Tips

- Fuel Handling Equipment. The Guidance clarifies that the property treated as part of a biomass plant to include fuel handling equipment at the plant site.
- Roadways. The Guidance also provides that roadways and paved parking areas used for the transport of material to be processed at a facility or for equipment used in maintaining or operating the site qualify as eligible property, but roads and parking lots used solely for employee or visitor traffic are not treated as integral parts of a qualified facility.
- Co-Firing. For a plant that intends to use both qualifying and non-qualifying fuel (under the relevant section 45 production tax credit rules), the Guidance provides that a percentage of eligible property equal to the expected percentage of electrically produced using qualifying fuel will receive the grant.

Open Issues

- Anti-Double-Dip Rule. The Guidance does not address whether landfill gas (“LFG”) facilities that take gas from old section 29 landfills and do not qualify for the section 45 production tax credit will nevertheless qualify for the ITC grant.
- LFG Collection Facilities. The Guidance states that a geothermal plant includes all the wells and pipes in a geothermal field. This raises the question of whether an LFG plant would include all of the wells and pipes at an integrated, single facility.

Leasing

The Guidance generally provides liberal rules in allowing the lease of property eligible for the cash grant. Either the lessor or the lessee can elect, through a written agreement between the two, to receive the grant. If the lessee is the recipient, it must

include 50% of the grant amount as taxable income (ratably over the 5-year recapture period). In such a case, the grant amount will be based upon the independently assessed fair market value of the property on the date the property is transferred to the lessee.

As discussed above, sale-leasebacks are also allowed.

Recapture

Of great interest are those provisions in the Guidance dealing with grant recapture. Recapture of grant funds is required if a facility that initially qualified for the grant is transferred to a disqualified person or ceases to qualify as “specified energy property” within the first 5 years of being placed in service. Recapture is generally pro-rated based on how many full years elapse between the placement in service date and the occurrence of the disqualifying event (e.g., 100% recapture before the first full year elapses, 20% of recapture between the 4th and 5th full year). This issue created concerns within the lending community about whether a secured lender could foreclose and transfer collateral assets without triggering a recapture requirement. The Guidance provides some reassurance.

Temporary cessation of energy production will not result in recapture if the owner intends to resume production at the time of cessation, however permanent cessation will result in recapture. It is unclear how and when this distinction will be tested.

Special rules also apply to biomass facilities that use some amount of non-biomass material for fuel. If the percentage of electricity produced from biomass is reduced, then a proportionate percentage of the facility will be treated as ceasing to be qualified property. No additional grant will be allowed if the percentage of energy produced from biomass increases.

A facility can be transferred to another eligible owner during its first 5 years after being placed in service without causing recapture to occur, but the original owner

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will be jointly and severally liable to the Treasury for the recapture amount with the new owner if the new owner subsequently causes a recapture event to occur. Special rules also apply to the transfer of ownership of a facility that is leased, subjecting the lessee to recapture risk that may be beyond its control.

A bond is not required to be posted in order to receive a grant, and no lien is created in favor of the U.S. government. However, amounts due under the recapture provision are debts owed to the U.S., and will be collected by "all available means against any assets of the applicant."

Open Issues

- Penalties of Perjury. Some of the required forms that must be submitted require representatives of the applicant to execute the forms under penalty of perjury. Will the U.S. Department of Justice pursue these agents acting on behalf of an applicant in their individual capacities in the event recapture amounts are not repaid by an applicant?
- Interest on Recapture. The Guidance does not specifically address whether interest will be required to be paid on grant money that must be returned upon a recapture event.

Additional Considerations

Reporting – The Guidance mandates annual reporting by grant recipients during the 5-year grant recapture period. Information on these reports must include the number of jobs "retained," energy production totals, capacity figures, and annual certification that no recapture event

has occurred. Grant recipients must also maintain certain records in case of an audit. Treasury is granted the right of physical access to an applicant's facilities and any pertinent books and records (including electronic records) of the applicant and each partnership or pass-thru entity that directly or indirectly owns an interest in the applicant, in order to conduct audits and examinations.

Other Federal Laws – The Guidance specifically provides that neither the Davis-Bacon Act (prevailing wage) nor the National Environmental Policy Act (enhanced environmental assessment and impact statements) requirements are triggered by receipt of the cash grant.

Assignability – An applicant may assign its right to receive a grant payment to a third party. This is a very useful feature in structuring a project financing.

Open Issues

- Reporting Waste or Abuse. The Terms and Conditions document requires that an applicant "must immediately report any indication of fraud, waste, abuse, or potentially criminal activity pertaining to Section 1603 funds to Treasury and the cognizant Treasury inspector general." How far does an applicant's obligation extend to report "waste or abuse" by their own employer or other parties? What exactly constitutes "waste or abuse"?
- Public Information. The amount of each grant will be public information, allowing just about anyone to backtrack into the cost of a project, potentially affecting commercially sensitive information.

We hope that you find the forgoing of interest. If you have any questions or would like to discuss the specifics of your project, please do not hesitate to contact us.

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