



TREASURY RELEASES GUIDANCE ON GRANT PAYMENTS FOR SPECIFIED RENEWABLE ENERGY PROPERTY IN LIEU OF TAX CREDITS

On July 9, 2009, the Office of the Fiscal Assistant Secretary of the United States Treasury Department released guidance (Guidance) on the implementation of Section 1603 of the American Recovery and Reinvestment Act (ARRA), which authorizes the Treasury to make cash payments to eligible persons who place in service specified renewable energy property by a certain credit termination date. Although the Treasury is not expected to accept applications for Section 1603 payments before August 1, 2009, the Guidance provides important insights on the application process, preparation of the application package, and how the relationships of various players in a renewable energy project should be structured to fully take advantage of the payment program.

The ARRA expanded investment tax credits (ITCs) under Section 48 of the Internal Revenue Code (Code) and allowed the elective conversion of production tax credits (PTCs) under Section 45 of the Code for renewable energy properties into ITCs. Additionally, Section 1603 of the ARRA provides an option for taxpayers to choose to receive a cash payment in lieu of the ITC (including those facilities eligible for PTC for which taxpayers are able to elect to claim the ITC) in light of the gap created by diminished investor demand for tax credits.

The direct payment provision is unusual because it in effect involves the administration of federal tax rules and concepts outside of the federal tax system. The delay in providing this guidance appears to have been largely because the “translation” (and some modification) of federal tax rules and concepts to apply to a grant program raised a number of novel questions for the Treasury to resolve.

This article summarizes the key features of the Guidance and its implications.

Property and Payment Eligibility

Qualified property must be originally placed in service between January 1, 2009 and December 31, 2010, or placed in service after 2010 and before the applicable tax credit termination date, if the construction of the property begins between January 1, 2009 and December 31, 2010. Qualified property includes expansions of an existing property that is qualified property under Sections 45 or 48 of the Code.

Credit Termination Dates and Applicable Payment Percentages. The credit termination dates and applicable percentages of eligible cost basis used in computing the payment for each specified energy property are as follows:





Specified Energy Property	Credit Termination Date	Applicable Percentage of Eligible Cost Basis
Large Wind	January 1, 2013	30 percent
Closed-Loop Biomass Facility	January 1, 2014	30 percent
Open-Loop Biomass Facility	January 1, 2014	30 percent
Geothermal Under Code Section 45	January 1, 2014	30 percent
Landfill Gas Facility	January 1, 2014	30 percent
Trash Facility	January 1, 2014	30 percent
Qualified Hydropower Facility	January 1, 2014	30 percent
Marine and Hydrokinetic	January 1, 2014	30 percent
Solar	January 1, 2017	30 percent
Geothermal Under Code Section 48	January 1, 2017	10 percent*
Fuel Cells	January 1, 2017	30 percent**
Microturbines	January 1, 2017	10 percent***
Combined Heat and Power	January 1, 2017	10 percent
Small Wind	January 1, 2017	30 percent
Geothermal Heat Pumps	January 1, 2017	10 percent

* Geothermal property that meets the definitions of qualified property in both § 45 and § 48 is allowed either the 30-percent credit or the 10-percent credit but not both.

** For fuel cell property, the maximum amount of the payment may not exceed an amount equal to \$1,500 for each 0.5 kilowatt of capacity.

*** For microturbine property, the maximum amount of the payment may not exceed an amount equal to \$200 for each kilowatt of capacity.

Placed-in-Service Date. Because eligibility depends on the placed-in-service date of property, the rules set forth in the Guidance defining the placed-in-service date are of key importance. In general, the Guidance follows well-established federal tax rules for determining when property is placed in service. For example, the Guidance generally provides that all components of a larger property are a single unit of



property if the components are functionally interdependent (so that, for example, each wind turbine on a wind farm, together with the tower and supporting pad, is treated as a separate unit of property).

Election to Treat Separate Units as a Single Unit. The Guidance also, however, provides for a favorable rule under which an applicant can elect to treat multiple units of property as a single unit of property with a single placed-in-service date if (1) the units are located on the same site and (2) the units will be operated as a single unit. This rule should, among other things, greatly simplify the application process for large projects.

- **Beginning of construction.** The Guidance generally follows the federal tax rule that construction begins when physical work of a significant nature begins. Under a safe harbor set forth in the Guidance, an applicant may treat physical work of a significant nature as beginning when the applicant incurs or pays more than five percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

With respect to whether components of a larger property are to be treated as a single unit of property, the Guidance follows the same approach as used to determine the placed-in-service date. Thus, for purposes of determining when the construction of property begins, the components of a larger property generally are a single unit of property if the components are functionally interdependent. The owner of multiple units of property that are located at the same site and will be operated as a larger unit may elect, however, to treat the units as a single unit of property. For example, the owner of a wind farm consisting of 50 turbines may treat the entire farm as a single unit of property. If such an election is made, failure to complete the entire planned unit before the tax credit termination date will not preclude the receipt of a Section 1603 payment with respect to the units completed before the tax credit termination date. This election provides particular benefits under the “grandfathering” rule for projects that commence construction before 2011.

Application Procedures

Timing. The Guidance provides that for property placed in service during 2009 and 2010, applications must be submitted after the property has been placed in service and before October 1, 2011. For property not placed in service but for which construction began in 2009 or 2010, application must be submitted after construction commences, but before October 1, 2011.

If the property is placed in service at the time of the application, the Treasury will make payment to qualified applicants within 60 days from the date the completed application is received. If the property has not been placed in service at the time of



the application, the Treasury will determine whether supplemental information is required. If supplemental information is required, applicants must submit the information within 90 days after the property is placed in service.

Form of Application. Taxpayers interested in applying for Section 1603 payments are required to apply online by completing an “**Application for Section 1603: Payments for Specified Renewable Energy Property in Lieu of Tax Credits.**” The form generally requires information identifying the recipient and detailed description of the project establishing that the eligibility requirements are met. The Guidance requires the following supporting information for all projects:

- Design plans (final engineering design documents, stamped by a licensed professional engineer).
- Cost basis payment documentation, including a detailed breakdown of all costs included in the basis. For properties in excess of \$500,000, an independent accountant’s certification attesting to the accuracy of all costs claimed as part of basis.

The Guidance requires the following supporting information regarding the placed in service date:

- A commissioning report (a report provided by a project engineer, the equipment vendor, or an independent third party that certifies that the equipment has been installed, tested, and is ready and capable of being used for its intended purpose).
- An interconnection agreement (required only for properties placed in service that are interconnected to a utility). The form also requires information regarding jobs created and retained as a result of the project.

The Guidance requires the following supporting information regarding the commencement of construction date:

- Paid invoices and/or other financial documents demonstrating physical work has begun.
- A binding contract (required for property not yet placed in service that is being manufactured, constructed or produced for the applicant by another person).

Eligible Applicants

Only an owner or lessee of specified energy property that is treated as the original user of the property can apply for a Section 1603 payment.



80/20 Rule for Used Property. The Guidance provides that if the cost of used parts contained within a facility is not more than 20 percent of the total cost of the facility, the applicant will be treated as the original user. This rule is comparable to the ITC rule.

Leased Property. A lessor that is eligible to apply for a Section 1603 payment may elect to pass-through the payment to a lessee if the lessee would be eligible to apply for the Section 1603 payment if the lessee were the owner. To make the election effective, the lessor must consent to the lessee being the recipient of the Section 1603 payment and the lessor must have waived its right to receive any payment under Section 1603 as well as its right to claim an ITC or a PTC with respect to the property. The lessee must agree to include ratably in gross income over the five-year recapture period an amount equal to 50 percent of the amount of the Section 1603 payment.

Sale-Lease Back. If new property is originally placed in service by a lessee and then sold to a lessor and leased back to the lessee by the lessor within three months after the date the property was originally placed in service by the lessee, then either the lessor or the lessee may claim the Section 1603 payment, depending on the agreement and elections made by the parties.

Tax-Exempt Investors and Governmental Entities Can Benefit From Section 1603 Payments Through Blocker C Corporations

The following four types of persons (Disqualified Persons) are not eligible to claim Section 1603 payments:

- Any federal, state, or local government, including any political subdivision, agency, or instrumentality thereof
- Any tax-exempt organization described in Section 501(c) of the Code
- A clean renewable energy bond lender, a cooperative electric company, or a governmental body described in Section 54(j)(4) of the Code
- Any partnership or other pass-through entity, any direct or indirect partner (or other holder of an equity or profits interest) of which is an organization or entity described above unless this person only owns an indirect interest in the applicant through a taxable C corporation

The Guidance provides a liberal interpretation of Section 1603 by allowing an otherwise ineligible entity to participate in a qualified project through a blocker C corporation inserted between the Disqualified Person and the partnership investing directly in a qualified project. This rule allows private equity funds with tax-exempt partners to apply for Section 1603 payments. Importantly, the Guidance provides that whether an applicant is treated as a Disqualified Person is tested as of the date



the application is received, so that it may be possible to restructure prior to the submission of an application to avoid Disqualified Person status.

The Guidance contains no limit on the percentage ownership interest in a tax partnership that may be held by a tax-exempt entity or governmental organization through a blocker C corporation; thus, the Guidance appears to permit a facility that is indirectly owned principally by tax-exempt or government organizations to receive 1603 payments. Further, a taxable C corporation owned by a governmental unit that is not treated as a government “agency” or “instrumentality” under Section 1603(g) of the ARRA would appear to qualify to receive a Section 1603 payment. While the Guidance does not directly address the definition of “agency” or “instrumentality” under Section 1603(g), it appears likely that a taxable C corporation with an independent board of directors would not be treated as a government agency or instrumentality for purposes of ARRA Section 1603(g). See, Code Section 168(h)(2)(D). Thus, although the Guidance is silent on the issue, it appears the Section 1603 payment in lieu of ITC may be used as a funding source for facilities that are indirectly owned principally by government bodies.

Recapture

The Guidance requires repayment of a portion of any Section 1603 payment if the energy property is transferred to a “Disqualified Person” or ceases to be “specified energy property” within five years after it is placed in service. The repayment (recapture) percentage is 100 percent if the disqualifying event occurs in the first 12 months following the placed in service date and is reduced by 20 percent for disqualifying events occurring in each of the next four 12-month periods. Although the repayment provisions in the Guidance generally mirror the ITC recapture provisions, there are several noteworthy distinctions, including:

- Permanent cessation of production due to “natural disaster” within the five-year period will **not** trigger repayment; most tax practitioners agree that destruction of a facility within the five-year period does trigger ITC recapture. However, the owner of the destroyed facility would be required to repay the Section 1603 payment if the owner uses Code Section 1033 to avoid gain on the receipt of insurance proceeds **or** if the owner seeks another Section 1603 payment for the replacement property.
- The Guidance clarifies that temporary cessation of production will not result in a repayment obligation as long as the owner intends to resume production. This is a broadly worded exception that provides significantly more comfort and flexibility than the existing ITC recapture rules.
- In perhaps the most important variation from the ITC recapture rules, the Guidance permits the owner of a facility to transfer the facility within the five-year recapture period without recapture as long as (1) the transfer is not to a Disqualified Person and (2) the facility remains



specified energy property in the hands of the purchaser for the remainder of the five-year period. This rule would also permit transfers of partnership or membership interests in a flow-through entity that owns the qualified facility. However, if there is a disqualifying event following a transfer, the purchaser and seller are jointly and severally liable for the repayment obligations.

These liberalized “recapture” rules make Section 1603 payment funding a significantly less risky funding source than the ITC subsidy.

Tax Treatment of Section 1603 Payments

With the exception of a lessor passing-through the Section 1603 payment to a lessee described above, a Section 1603 payment is not taxable income to the recipient, and the depreciable basis of the energy property is reduced by only 50 percent of the payment. This treatment “mirrors” the ITC benefit in lieu of which the payment is made. However, in the context of a tax partnership, the Guidance does not address whether the Section 1603 payment constitutes “tax-exempt income” that would result in a tax basis increase for the parties’ interests in the tax partnership. In addition, the proper GAAP treatment of Section 1603 payments must be considered.

Terms and Conditions

Each applicant is required to execute a Terms and Conditions document under penalties of perjury as a part of the application, evidently in large part because the Treasury does not automatically by operation of law have the same powers to compel payments with respect to an applicant that it has with respect to taxpayers under the Code. The Terms and Conditions require the applicant to agree to make recapture payments when required and to otherwise return to the Treasury any amounts to which the applicant is not entitled. The Terms and Conditions require that the applicant remain liable for its obligations notwithstanding any sale or other disposition of the property.

The Terms and Conditions do not subject the applicant to any federal income tax penalties for incorrect statements, but do clearly indicate that the applicant could be subject to other federal penalties for making materially inaccurate or incorrect statements.

Significantly, any amount subject to recapture is treated as a debt owed to the United States, but the applicant is not required to subject the property to a lien or post bond as a condition of receiving a Section 1603 payment.



The Terms and Conditions require annual reports and certifications relating to continued eligibility. The applicant also is required to maintain records and agree to be subject to audit; these agreements appear to be intended as the counterparts to the rules that require taxpayers to maintain records that enable the IRS to audit taxpayers.

Assignment of Payment

The Guidance provides that an applicant may submit, along with its request for payment, a Notice of Assignment, assigning the Section 1603 payment to a third party including a lender. Under the Federal Assignment of Claims Act, any assignment of a claim against the United States is not effective unless the claim has been allowed, the amount of the claim has been determined, and authorization for payment has been issued. It is not clear how the Treasury will process a Notice of Assignment of Section 1603 payment under the Federal Assignment of Claims Act. Presumably, a Notice of Assignment is not effective until the specified energy property has been placed in service and the complete application package has been provided to the Treasury.

Form of Guidance

The Guidance is in the form of a posted “Program Guidance” document and is not provided in the form of a regulation that is published in the Code of Federal Regulations or other official federal government published guidance vehicle.

This is unlike federal tax guidance, which typically is provided in the form of formal regulations, notices, or rulings published in the Internal Revenue Bulletin. Among other things, although the Treasury invites questions on the Guidance, it does not appear to be subject to the public comment process that generally applies to proposed and temporary regulations. The relative informality of the Guidance probably is attributable to the need for prompt implementation of this important provision of the ARRA, but possibly may raise some questions as the program proceeds.

Although the practical significance of this form of guidance is not yet clear, it may be noted that a number of the provisions in the guidance are favorable to applicants and possibly could be subject to challenge by third parties (for example, the provision stating that a Section 1603 payment does not make the property subject to the National Environmental Policy Act (NEPA)). In those cases, it is possible that courts may be less deferential to favorable guidance provided in this relatively informal format.

In addition, although the Treasury appears to have been careful not to label the Guidance as guidance under the Internal Revenue Code, the Guidance does set forth a number of interpretations of the federal tax consequences of receiving a Section



1603 payment. Additionally, in many cases, interpretations of the Guidance will necessarily make reference to the comparable federal tax rules.

Confidentiality

The Guidance provides that the application is not confidential and may be shared with the IRS and others. This is unlike tax return information, which is generally required to be treated as confidential by the Treasury under Section 6103 of the Code.



SPECIFIED RENEWABLE ENERGY PROPERTY: APPLICATION PROCESS DATES FOR PAYMENTS IN LIEU OF INVESTMENT TAX CREDIT

	Property Placed in Service in 2009 and 2010	Property Placed in Service After 2010
Original Application	After the property has been placed in service and before October 1, 2011	After commencement of construction and before October 1, 2011
Treasury Review	60 days from date completed application is received	If project is placed in service at time of application, 60 days from date completed application is received
Supplemental Submissions	If Treasury determines application not complete, 21 days permitted to submit a supplemental application	If property not yet placed in service and Treasury determines supplemental information is required, applicants must submit a supplemental application within 90 days of placed in service.
Payment	No later than five days from date of Treasury notice of final approval	No later than five days from date of Treasury notice of final approval



SPECIFIED RENEWABLE ENERGY PROPERTY: INVESTMENT TAX CREDIT AS COMPARED TO PAYMENTS IN LIEU OF INVESTMENT TAX CREDIT

	Investment Tax Credit	Direct Payment
Type of Subsidy	Tax credit; benefit realized when income tax payments due for year property placed in service	Direct payment; benefit realized within 65 days of placed in service date (generally earlier than comparable tax benefit)
Federal Return Filing/Application Detail	Notice 2009-52 and Form 3468	Comparable to tax return form, but requires third-party statements and more detailed information
Treasury Review of Application	No upfront review	Detail and procedures for Treasury review of applications is not yet clear
Recapture	Recapture possible in more types of dispositions and events	Recapture only required if (1) property is disposed to a nonqualified person, (2) a change to nonqualifying use
Favorable Commencement of Construction Rules	No express five-percent safe harbor rule, although possibly the safe harbor rule could be applied by analogy	Five percent safe harbor (other than for preliminary expenditures)



	Investment Tax Credit	Direct Payment
Grandfathering for Projects Placed in Service After 2010	No comparable election for favorable grandfathering is currently provided	Election to treat multiple units as a single unit provides for favorable grandfathering for multiple units on the same site
Original User Requirement	80/20 rule for used property should apply; 90-day period for sale/leaseback should be permitted	80/20 rule for used property; 90-day period for sale/leaseback permitted
Requirement for Annual Reports and Certifications	None, other than annual income tax returns	Filing of detailed annual reports and certifications required
Audit Procedures	Normal procedures for IRS examinations apply	Subject to audit and accountability provisions; terms and conditions contemplate broad audit authority
Appeal Rights Upon Adverse Enforcement Action	Rights for appeal and judicial review well established	Terms and conditions provide Treasury “will provide the opportunity for hearing, appeal or other administrative proceeding”, but exact nature of appeal proceedings permitted is not clear



	Investment Tax Credit	Direct Payment
Statute of Limitations	In most cases, a three-year limitation period on assessment applies	Statute of limitations is not stated; some uncertainty in light of terms and conditions agreements
NEPA and Similar Environmental Requirements	Should not apply because of tax credit, although has been subject to litigation	Program guidance provides NEPA does not apply, but novelty of direct pay regime possibly could give rise to litigation
Davis-Bacon Act	Does not apply because of tax credit	Program guidance provides Davis-Bacon Act does not apply
Penalties for Incorrect Statements	Federal tax accuracy-related penalties (20 percent or 40 percent) could apply; Section 6700 for false or fraudulent statements	Federal tax penalties appear not to apply, but other federal penalties for false or misleading statements could apply
Confidentiality	Return information confidential	Application information not confidential