

### Climate Alert

Significant Climate Change-Related News and Updates from the LLB&L Climate Change Practice Team

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## Treasury Opens the Vault: Applications Now Being Accepted for Renewable Energy Cash Grants

The American Recovery and Reinvestment Act of 2009, commonly known as the Stimulus Bill, signed into law on February 17, 2009, contained numerous provisions designed to stimulate investment in and development of renewable energy projects and technologies. One of the more significant of those provisions was Section 1603, which provides a non-discretionary cash grant (the "Grant") from the Department of the Treasury ("Treasury") for the placing in service of "specified energy property," which may be elected in lieu of claiming the Internal Revenue Code ("IRC") § 48 investment tax credit ("ITC") or the IRC § 45 production tax credit ("PTC"), collectively with the ITC, the "Tax Credits"). Until recently, no details were available concerning how the Grant program would work, what eligibility requirements would apply, or when the Treasury would begin accepting Grant applications. On July 9, the Treasury finally released its highly anticipated guidance on the Grant program, and on July 31, it announced that it would begin accepting applications for Grants immediately. The guidance provides a fairly extensive roadmap to the Grant application process, including a sample application form and standard terms and conditions, though certain issues remain in need of further clarification.

### Application Timing and Deadlines

According to a release issued by Treasury this past Friday, July 31, 2009, it began accepting applications for the Grant program on that date. All applications must be submitted by the statutory deadline of October 1, 2011, including projects that have not yet been placed into service but for which construction began in 2009 or 2010. Applications will be reviewed by technical personnel at the Department of Energy's National Renewable Energy Laboratory in Golden, Colorado. In the event any information is missing from an applicant's submitted application, the reviewing technician will contact the applicant directly and the applicant will have 21 days to respond. Treasury has indicated that the reviewers will not reject an application for missing information even if it will take more than 21 days to provide that information, as long as the applicant engages in an ongoing dialogue with the reviewer and is working diligently to provide the missing information. Grants will be paid within 60 days after receipt of a complete application or the date the project is placed in service, whichever is later. The Grants are non-

discretionary; therefore, any qualifying project for which a complete application is submitted will receive a Grant. Notably, the Grant program has been given an open appropriation, so all approved applications will be funded. The Treasury expects to receive more than 5,000 applications and to issue as much as \$3 billion in Grants during the life of the program.

Grant applicants should be aware that certain information regarding Grant recipients may be made public. The Treasury indicated that this likely will be limited to the name of the applicant, the type, location and description of the project, and the amount of the Grant awarded.

### Eligible and Ineligible Applicants

As is the case with the specified energy property itself, applicants must meet certain conditions to be eligible for a Grant. To receive a Grant, (i) an applicant must be an owner or lessee of specified energy property, and (ii) such applicant must have originally placed the property in service. Property will be considered placed in service when the property is ready and available for its specified use. In order to demonstrate that property has been placed in service, the guidance indicates that the applicant must submit a report provided by the project engineer, the equipment vendor or an independent third party certifying that the equipment has been installed, tested and is ready and capable of being used for its intended purpose.

The following four categories of persons and entities are not eligible for the Grant: (1) any federal, state or local government (or any political subdivision, agency, or instrumentality thereof); (2) any organization described in IRC Section 501(c) and exempt from tax under IRC Section 501(a); (3) any clean renewable energy bond lender, cooperative electric company or governmental body as referred to in paragraph 4 of IRC Section 54(j); and (4) any partnership or pass-thru entity, any direct or indirect partner of which is an organization or entity described in categories (1) through (3) above, unless the person only owns an indirect interest in the applicant through a taxable C corporation. These restrictions on applicant eligibility have important implications that must be considered when structuring a project for which a Grant will be sought.

## Property that Qualifies for the Grant

Grants are available for “specified energy property,” which includes depreciable (or amortizable) tangible personal property and other tangible property (excluding buildings) as defined in Sections 1.48-1(c) and (d) of the federal Income Tax Regulations. The tangible personal property must be an integral part of a renewable energy facility, must be located at the facility, and must have a business use. Capital improvements to existing projects may be eligible for the Grants but only with respect to capital expenditures incurred after December 31, 2008. The size of the Grant that can be awarded is based on the applicant’s cost basis in the specified energy property, as more fully described later in this article.

Specified energy property also must meet one of the following two timing conditions to qualify for a Grant: (1) the property must be placed in service during calendar years 2009 or 2010; or (2) construction of the property must begin prior to December 31, 2010, and the property must be placed in service prior to the “credit termination date” set forth below for the specific type of property. The following table provides a list of categories of property that are considered “specified energy property,” along with the “credit termination date” by which property in each category must be placed in service to be eligible for a Grant, and the applicable percentage of eligible cost basis for which a Grant may be issued:

Specified Energy Property	Credit Termination Date	Applicable Percent of Eligible Cost Basis
Large Wind	January 1, 2014	30 percent
Closed-Loop Biomass Facility	January 1, 2014	30 percent
Open-Loop Biomass Facility	January 1, 2014	30 percent
Geothermal under IRC 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 & Hydrokinetic	January 1, 2014	30 percent
Solar	January 1, 2014	30 percent
Geothermal under IRC Section 48 (*)	January 1, 2017	10 percent
Fuel Cells (**)	January 1, 2017	30 percent
Microturbines (***)	January 1, 2017	10 percent
Combined Heat & 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 IRC Sections 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.

## “Under Construction” and the 5 Percent Safe Harbor

One of the key questions that the Treasury sought to address in the guidance is how to determine when property is considered “under construction” for purposes of meeting the eligibility deadlines in the statute. According to the guidance, to be considered “under construction,” physical work of a significant nature must have begun. Preliminary activities such as planning or designing, securing financing, exploring or researching, including clearing or soil testing, do not qualify; however, excavation for footings and foundations would qualify. For property that is manufactured, constructed or produced for the applicant by another person under contract, construction begins when physical work of a significant nature begins under a binding contract even if no work has begun on the actual site of the project. Certain contracts may not be considered binding if they limit damages to a specified amount (such as liquidated damages) or include conditions that are within the control of one or more of the contracting parties. It is essential to understand these limitations when negotiating and drafting the relevant construction contracts. Importantly, the Treasury has established a safe harbor which allows an applicant to treat physical work of a significant nature as beginning when the applicant incurs (in the case of an accrual basis applicant), or pays (in the case of a cash basis applicant) more than 5 percent of the total cost of the property (excluding the cost of land and preliminary activities). If property is being manufactured or constructed for the applicant by a third party under contract, the

applicant itself must meet this test, not the contractor or manufacturer.

## Calculating and Certifying the Cost Basis

The same rules used for determining the basis of property for federal income tax purposes apply when determining the cost basis for purposes of the Grants. In general, a taxpayer’s “cost basis” in the property is the cost of the property placed in service after 2008, unreduced by any other adjustment to basis such as depreciation. However, costs that are deducted for federal income tax purposes in the year in which they are paid or incurred (e.g., IRC Section 179 deductions) are not includible in the “cost basis” on which the Grant payment is determined. Only the costs that were incurred for property placed in service after December 31, 2008, may be included in the “cost basis.” Costs incurred in 2009 or 2010 for specific property that is placed in service at a qualified facility in 2009 or 2010 may be included in the “cost basis” even if the qualified facility itself was placed into service prior to December 31, 2008. Cost basis further excludes the portion of the cost of the facility that is attributable to a non-qualifying activity, although there are some exceptions for modifications to existing facilities.

Applicants are required to submit documentation supporting the calculated cost basis, including a detailed breakdown of all costs included in the basis. Other supporting documentation such as contracts, invoices and proof of payment should be retained and must be submitted to Treasury upon its request. The guidance states that applications for Grants relating to properties with a cost basis in excess of \$500,000 must include an independent accountant certification attesting to the accuracy of all costs claimed as part of the basis. After issuing the guidance, the Treasury received a significant number of inquiries as to what form this “certification” must take (e.g., review, audit, under tax preparer penalty rules, etc.). In conjunction with the opening of the Grant program for applications, the Treasury has released additional guidance stating that for applications

requesting Grants of \$1 million or more for a specified property the independent accountant's certification must be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants ("AICPA"). Applicants requesting grants of less than \$1 million for property that has a cost basis in excess of \$500,000 may instead submit a report of Agreed-Upon Procedures ("AUP") prepared by an independent accountant in accordance with attestation standards of the AICPA. The AUP requires the accountant to attest that (i) the cost basis submitted by the applicant has been determined in accordance with published guidelines, (ii) all costs qualify as eligible in calculating that cost, and (iii) the costs submitted were incurred for the specified property. The accountant is required to review a large enough sample of the documentation to provide an independent confirmation that the costs submitted in the application were actually incurred for the property and that the property exists.

### Recapture of Grants

If within five years of placing the property in service the applicant disposes of the property to an ineligible person or the property fails to qualify as "specified energy property," the applicant must repay the Grant to the Treasury on a declining, pro-rata basis as follows:

Disqualifying Event Occurs	Repayment Percentage
Within one year	100 percent
After one year and before two years	80 percent
After two years and before three years	60 percent
After three years and before four years	40 percent
After four years and before five years	20 percent

There is no requirement that an applicant post a bond as a condition of receiving the Grant and no liens are created on property in connection with a Grant; however, funds that must be repaid to the Treasury under the recapture are considered debts owed to the United States (they are not considered tax liabilities). In the event the property is disposed of, other than as a result of the sale of the project company, the appli-

cant remains jointly liable to the Treasury for the recapture amount regardless of whether the applicant has control over the property after the transfer.

### Reporting Obligations and Other Obligations

Grant recipients will be required to submit annual reports to the Treasury to verify that the property continues to qualify as a specified energy property and that nothing has occurred that would trigger recapture. The Treasury has indicated that it will require disclosure of production levels in these reports but that such information will not be used for purposes of evaluating the project as long as the project continues to produce some amount of energy. This information may be used for statistical purposes to determine and report on the aggregate amount of energy produced in connection with the program. The Treasury expects to release additional information regarding the reporting requirements related to the number of jobs retained and the designation of employees in certain offices or positions.

Unlike some of the other programs implemented under the Stimulus Bill, payment of a Grant does not make the property subject to the requirements of the National Environmental Protection Act (NEPA) (because issuance of a Grant is non-discretionary), the Davis-Beacon Act or the Buy American requirements.

### Tax and Structuring Concerns

One of the prevalent methods of financing large renewable energy projects such as wind farms in recent years has been tax equity financing, in which the project is owned by a partnership with a large institutional investor and equity is raised by transfer of the Tax Credits and depreciation to the investor. Early indications are that many developers will seek to employ Grants in tax equity financing. The Treasury's guidance clearly states that Grant proceeds received by an applicant are not included in the taxable income of the taxpayer (with potential exceptions in the case of leased property), but instead reduce the basis of the specified energy property by an amount

that is equal to 50 percent of the Grant received. However, a key issue that has not been addressed by the Treasury is whether, when the Grant is received by a partnership, the Grant itself and the subsequent distribution of the Grant's funds to the partners will be treated as tax-exempt income. Under the current federal income tax rules for partnerships, a partner's basis in its partnership interest increases by its distributive share of the partnership's tax-exempt income. Likewise, when the partnership distributes cash or property, whether arising out of tax-exempt or taxable income, such partner reduces its basis in its partnership interest. Furthermore, under these rules a partner generally only recognizes a taxable gain on a distribution when a cash distribution to a partner exceeds that partner's basis in its partnership interest. The effect of these federal income tax rules is to preserve the tax-free character of the tax-exempt income received by a partnership applicant. Given the prevalent use of partnerships as project companies for purposes of tax equity financing, which is expected to continue and be enhanced by the availability of the Grant, it is widely considered vital for the Treasury to provide further guidance adopting these rules. However, Treasury officials have indicated that they view this as a tax issue within the purview of the IRS. Accordingly, this issue bears watching closely as the Grant program and its use in tax-equity financing evolve.

### Factors in Selecting Grant vs. Tax Credits

Since the Grant is taken in lieu of the Tax Credits, a threshold decision must be made as to whether the applicant should take the Grant instead of one of the Tax Credits. This decision requires a careful assessment of the individual characteristics of a project, as well as the application of the ITC and the PTC. The PTC is designed to benefit companies that promote and utilize renewable energy and other technologies over the first ten years of a facility's operation. The ITC benefits these same types of companies and projects, but is based on a percentage of the qualifying cost of the project and is claimed entirely in the tax year in which

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the project is placed in service. There are other notable disparities to take into consideration as well, such as differences in depreciation calculations between projects qualifying for the PTC and projects qualifying for the ITC. Further, choosing a Grant instead of claiming the ITC could affect a project owner's ability to take advantage of other grants or state tax benefits that it may otherwise depend on for funding. For these reasons, each project's projected cost and output should be compared using the ITC, the PTC and the Grant. The following is a quick comparison of certain key business issues relating to the Grant and the Tax Credits that should be considered when making the election decision:

Key Business Issues	Grant In Lieu of Credits	Section 48 Investment Tax Credit	Section 45 Production Tax Credit
Requires adequate tax capacity to utilize benefits (i.e., ample federal taxes)	Not required	Required	Required
Time of Benefit	Later of 60 days from date of application or placed in service	Claimed as a tax credit on the applicable federal income tax return in the first year property is placed in service	Claimed as a tax credit on the applicable federal income tax return over 10 year period, based on electricity produced
Amount of Benefit	Up to 30 percent of basis in "specified energy property" (typically a lower benefit than the Section 45 Credit, but the benefit is potentially obtained within 60 days of placed service)	Up to 30 percent of basis in certain energy property (typically a lower benefit than the Section 45 Credit, but obtained on the tax return for the year placed in service)	Up to 2.1 cents per kilowatt-hour for electricity produced from renewable sources (typically a larger benefit than the Section 48 Credit Grant, but obtained over 10 years)
Cost Associated with Benefit	50 percent basis reduction (and thus lower depreciation in the future); Recapture of grant in the future upon certain events; Loss of ability to claim Sections 48 or 45 Credits	50 percent basis reduction (and thus lower depreciation in the future); Recapture of credit in the future upon certain events; Loss of ability to claim Grant or Section 45 Credit	Loss of ability to claim Grant of Section 48 Credit and ten year recovery of benefit

Of course, there are many other important and nuanced considerations that must be weighed when determining whether to claim a Grant, the PTC, or the ITC, not all of which can be discussed in a brief article. For further information, please contact any of the persons referred to in the column to the left of this *Client Alert*.

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