



Renewable Energy Alert

A publication of Nixon Peabody LLP

JULY 14, 2009

IRS guidance on claiming a payment in lieu of investment tax credits for solar, fuel cells, wind, biomass, geothermal, and other facilities

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This *Alert* continues our series on energy provisions in the American Recovery and Reinvestment Act of 2009 (ARRA). In this *Alert*, we discuss the just-released rules under Section 1603 of ARRA for converting the investment credit into a payment (a Section 1603 Payment¹).

First, a quick refresher course on credits and payments.

Investment tax credits for renewable energy. Through 2016, solar and fuel cell projects continue to be eligible for a 30-percent tax credit (with a cap of \$3,000 per kwh for fuel cells), and, through 2013, a wide assortment of PTC-eligible facilities *that generate electricity* can *elect* the 30-percent investment credit (*instead of* the PTC). These include wind (only through 2012), biomass,² geothermal, trash, solid waste, marine, and hydro. Finally, combined heat and power facilities and geothermal projects are eligible for a 10-percent credit through 2016.³

Section 1603 Payment in lieu of credit program. Any of the kinds of facilities described in the preceding paragraph can *elect instead* to receive a payment⁴ from the federal government, based on the same percentages as described above. The payment is only available for projects that are placed in service in 2009 or 2010, or which are commenced in 2009 or 2010, and then placed in service during the periods described above, i.e., through 2016 for solar, fuel cells, and 10-percent geothermal; through 2012 for wind; and through 2013 for all others.

Which brings us to the latest from Treasury. Treasury has now provided guidance and a draft application for claiming Section 1603 Payments. The complete package of materials can be found on the Internet, at <http://www.treas.gov/recovery/1603.shtml>. What follows is a brief summary that addresses the highlights in the Guidance. Please feel free to contact any of us, should you want to discuss the finer points or how these rules will affect your transactions.

¹ The Treasury guidance refers to these as “payments,” rather than “grants.”

² Note that “biomass” is not “biodiesel,” and the generation of methane gas is *not* in any of these categories, unless the facility then converts the gas into electricity.

³ As we’ve discussed in past *Alerts*, geothermal that generates electricity is eligible for a 30-percent credit if placed in service through 2013, and a geothermal project is otherwise eligible for a 10-percent credit if placed in service through 2016.

⁴ Projects are eligible for a payment *or* credits, but *not* both.

Deadlines and timetables

1. *Starting date.* A form of application has been posted on the Internet, but Treasury will not be accepting applications until August 1, 2009. Treasury has indicated that the form may still change before it becomes final on August 1, and all applications will be filed electronically.
2. *Pre-2011 projects.* If a project is placed in service (PIS) in 2009 or 2010, it is eligible for a Section 1603 Payment, regardless of how much work was done before 2009. When a facility is PIS before December 31, 2010, the application is submitted *after* PIS. For projects relying on the “began construction in 2009 or 2010, but didn’t finish until 2011 or later” rule, see the discussion below, under the heading “Special rules for projects not placed in service in 2009 or 2010.”

Eligible property

3. *Basic rules.* Property eligible for a payment must be “described in Section 48.” The Guidance provides a couple of specific expenditures that are *not* eligible, such as buildings and trucks on which solar property is mounted.
4. *“Integral part” and illustrations.* The property must be tangible property that is an integral part of the facility and located at the facility. Treasury gives two interesting illustrations: (i) roads and parking for material that will be processed at the facility, or which are used in operating or maintaining the facility, are *eligible* for payments; (ii) roadways and parking lots that provide *solely* for employee and visitor traffic are *ineligible*. The Guidance contains additional illustrations of qualifying property for biomass, geothermal, and other facilities, noting that any facilities that are offsite are ineligible, as are trucks, railroad cars, and barges that transport biomass or waste to the facility.
5. *New property.* Like tax-credit-eligible property, the property must be at least 80-percent “new” to qualify for a payment.
6. *Located in the U.S.* Property must be physically located in the U.S. at least 50 percent of the year to qualify.
7. *Tax-exempt and governmental entities.* As we’ve discussed in prior *Alerts*, a Section 1603 Payment is not available to certain persons, particularly, a pass-through entity that includes *any* governmental or tax-exempt entity, no matter how small its interest. Treasury has now made clear that a “blocker corporation” (i.e., a for-profit C corporation) can be interposed between the not-permitted entity and the asset. The Guidance does *not* require that a Section 168(h) election be filed, and Treasury will allow a blocker to be added *after* PIS, but *before* the application is submitted. Remember, however, that adding a non-electing blocker after PIS will put the energy credit at risk if the grant application is denied.

Attachments to the application

8. Treasury requires a great deal of paperwork and information:
 - a. The applicant’s DUNS number from Dun and Bradstreet (a number can be obtained for free by calling the number provided in the Guidance).
 - b. Plans stamped by a licensed professional engineer.
 - c. Documentation relevant to the particular facility (e.g., nameplate capacity, where appropriate, or FERC certification and license for a hydro facility).
 - d. A commissioning report provided by the project engineer, the equipment vendor, or an independent engineer certifying that the equipment has been installed, tested, and is ready and capable of being used for its intended purpose.
 - e. An interconnection agreement (and follow-up documentation), where appropriate.

- f. A lease, where appropriate.
- g. A detailed breakdown of all costs included in basis. Supporting documentation, such as contracts and invoices, should be kept by the applicant and made available to Treasury upon request.
- h. If the cost basis in the facility is more than \$500,000, an independent accountant's certification of costs.
- i. A signed copy of the "Terms and Conditions," posted at the Internet site provided above. Treasury has indicated that the Terms and Conditions will not apply if the applicant does not receive a Section 1603 Grant and, therefore, the applicant would be able to claim the investment tax credit with respect to the qualified property if the project otherwise qualifies for the credit.

Costs eligible for the payment.

- 9. *General rule.* In general, the payment will be based on the basis in the property for federal income tax purposes. Items for which a deduction is claimed (e.g., the Section 179 expensing deduction) are not included in basis.
- 10. *Allocating costs.* Where a facility has both a qualifying and a non-qualifying use, the Guidance generally calls for allocation based on the percentage of electricity produced using each technology. Despite this general rule, all costs are included where the expenditures are entirely committed to a renewable modification of an existing facility.
- 11. *Lease pass-through structure.* Where the "lease pass-through" or "inverted lease" method is used (which allows the lessee to claim the payment, instead of the owner), the payment is based on the "independently assessed fair market value" at the time the property is transferred to the lessee. The Guidance requires the parties to provide "all information necessary to determine the amount of the lessee's Section 1603 Payment," although it does not specifically require an appraisal. Note that, like the lease pass-through structure in an investment tax credit situation, the lessee is required to recognize "anti-depreciation" of one-half of one-fifth (i.e. one-tenth) of the Section 1603 Payment into income annually for a five-year period.

Payment dates

- 12. *The basic 60-Day rule.* Treasury is obligated to provide a payment within 60 days of its receipt of a *completed* application. As we've reported previously, Treasury will extend this date somewhat by considering an application "incomplete" if it needs more information (and presumably more time) to complete its review. Applicants will have 21 days to respond to a request for additional information. Note that failure to meet the 21-day period will result in the application being denied, and Treasury's current position is that this irrevocably terminates an applicant's ability to get a Section 1603 Payment (but not a tax credit) with respect to the property in the denied application.
- 13. *Electronic funds transfer.* Treasury will transfer the Section 1603 Payment electronically within five days of reporting that the application is complete.

Recapture

- 14. *Cause of recapture.* As we reported previously, a mere disposition of the facility will not cause recapture. Instead, there must be a "disqualifying event," which can include:
 - a. The property is no longer used in a way that qualifies for a Section 1603 Payment (e.g., where a renewable energy facility is converted to run on coal or natural gas).
 - b. There is a transfer of the property or an interest in the applicant to a government or tax-exempt entity.

- c. In a lease pass-through structure, there is a transfer of (i) the lessee's rights under the lease, or (ii) an interest in the lessee to a non-permitted entity, such as a government or tax-exempt entity.
- d. Use of the property predominantly outside the U.S.
- e. Permanent cessation of production, except if due to a natural disaster, unless certain exceptions to this exception apply; for example, the recapture exception will not apply if the taxpayer takes advantage of Internal Revenue Code Section 1033 (no gain is recognized on account of certain "involuntary conversions") when replacing the equipment with new equipment or if it receives a second Section 1603 Payment with respect to replacement property.

Finally, special rules apply to hydro and geothermal projects.

- 15. *Sale or foreclosure.* A sale or foreclosure with respect to the asset will not cause recapture provided the person acquiring the facility agrees to be jointly liable for subsequent recapture, if applicable, and the property continues to be used as specified energy property. Sale of an ownership interest will *not* cause recapture, nor will distribution of the Section 1603 Payment to one or more partners, stockholders or creditors of the applicant.
- 16. *Amount of recapture.* Like the energy credit, recapture is 100% in the first year, 80% in the second, and so on.
- 17. *Repayment.* The applicant is required to make repayment to the US Treasury, and the Department of Justice will enforce the collection obligation. The government will not take a lien on the property in connection with making a Section 1603 Payment, although it might take a lien as a judgment creditor if it is forced to litigate its claim.

Special rules for projects not placed in service in 2009 or 2010

In addition to the rules described above, special rules apply where the facility is not placed in service in 2009 or 2010, *provided* construction began in 2009 or 2010. Note that, if a project was started in 2008, then it *must* be placed in service in 2009 or 2010 to qualify for a Section 1603 Payment.

- 18. *Deadlines.* For projects that were not placed in service in 2009 or 2010, but for which construction began in 2009 or 2010, a preliminary application must be submitted after construction commences and before October 1, 2011, indicating that the project will be PIS after 2010. A final application must then be submitted within 90 days after the property is placed in service.
- 19. *When does construction begin?* In general, construction begins when "physical work of a significant nature" begins. Clearing a site or test drilling is *not* sufficient. Work done by a contractor on behalf of the applicant is sufficient only if (i) the contractor's work is physical work of a significant nature *and* (ii) the work is done pursuant to a written, binding contract that is enforceable under local law, provided damages are not limited to less than 5 percent of the total contract price. The Guidance provides further rules about conditional contracts, modifications, and terms that remain to be negotiated, each of which may be permitted if the rules are met.
- 20. *Safe harbor.* Incurring more than 5 percent of the total cost of the property (not including land or preliminary costs, such as designing or seeking financing) will meet the test of the preceding paragraph. As a safe harbor, passing this test is sufficient, but not necessary to show that construction has begun.
- 21. *Units of property.* Each facility that can be separately operated and metered is considered a "unit," and all units located at the same site and which will be operated as a "larger unit" can be analyzed together for the purpose of these deadlines. As we discussed in our last *Alert*, if the actual project is not as large as anticipated, this will not prevent the smaller project from complying with the rules.

Miscellaneous

22. *Assignment of the Payment.* An applicant may assign the payment to someone else, pursuant to the Federal Assignment of Claims Act. For example, this might be used to satisfy an obligation to a lender.
23. *Other Forms of Ownership.* Treasury is considering how other forms of project ownership, e.g., tenants in common, should complete the application.
24. *NEPA and Davis-Bacon.* The Guidance says that a Section 1603 Payment will not cause either to apply to a project. It should be noted that Treasury's view is not binding on litigants who may seek a different result in the courts.
25. *Payments are not taxable income.* Section 1603 Payments are not taxable income, but the owner's basis in the Project is reduced by 50 percent of the amount of the Section 1603 Payment. There is one exception: in a pass-through structure, there is no basis reduction, but the tenant will have "anti-depreciation" income as described in Paragraph 11 above.
26. *Annual certifications.* The applicant must provide annual certifications to Treasury as to ownership, capacity, output, and jobs.

For more information regarding the ITC, the PTC, Section 1603 Payments, or this *Alert*, please contact:

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