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Additional Renewable Energy Cash Grant Guidance Released Regarding When Construction Begins

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The Treasury Department has released additional guidance in the form of a list of questions and answers (the "Q&A") regarding when construction begins for projects placed in service after 2010 by applicants applying for cash grants in lieu of renewable energy tax credits under Section 1603 of the American Recovery and Reinvestment Tax Act of 2009.

As detailed below, the Q&A:

- Indicates that for applicants attempting to meet the physical work of a significant nature test, any physical work on the specified energy property will satisfy the "begin construction" requirement, subject to a new continuous construction standard;
- Cautions that work performed under a contract does not include work to produce components or parts normally held in inventory by a manufacturer for purposes of the physical work of a significant nature test;
- Clarifies that the economic performance test continues to apply to accrual method applicants; and
- Provides that 5% of actual (rather than projected) costs must be paid or incurred by the applicant to meet the 5% safe harbor test.

To qualify for a cash grant, a taxpayer must place "specified energy property" in service in 2009 or 2010, or after 2010 if construction begins in 2009 or 2010 provided such property is placed in service by the end of 2012 (for wind), 2013 (for closed- and open-loop biomass, geothermal, landfill gas, municipal solid waste, qualified hydropower, and marine and hydrokinetic facilities), or 2016 (for solar). With only a half year left to satisfy the "begin construction" requirement, the Q&A provides further clarity to assist developers, investors, and lenders alike.

The Q&A follows guidance released in March 2010 which modified the beginning of construction requirements contained in the original July 2009 guidance (the "Program Guidance"). Our client alerts detailing the March 2010 revisions, as well as the original Program Guidance, can be found at:

- http://www.paulhastings.com/assets/publications/1559.pdf?wt.mc_ID=1559.pdf and
- http://www.paulhastings.com/assets/publications/1367.pdf?wt.mc_ID=1367.pdf.

As indicated in the original Program Guidance, the Q&A provides that there are two ways to show that construction has begun. The first is to begin physical work of a significant nature. The other is to pay or incur at least 5% of the total cost of the specified energy property before the end of 2010.

Physical Work of a Significant Nature

Emphasis on "Specified Energy Property". Both the Program Guidance and the March 2010 revisions to such provided that construction begins when "physical work of a significant nature begins." The March 2010 revisions clarified that both on-site and off-site work may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. The Q&A specifies that to begin physical work of a significant nature means that physical work on the specified energy property has started. Notably, throughout the Q&A, the more specific term "specified energy property" is used instead of simply "property."

In the case of a qualified facility described in Code Section 45, specified energy property is limited to tangible personal property and other tangible property used as an integral part of the activity performed by the qualified facility and located at the site the qualified facility. The Q&A provides that for such a facility, specified energy property includes property integral to the production of electricity, but does not include property used for electrical transmission. Thus, physical work on a transmission tower located at the site is not physical work of a significant nature because the transmission tower is not part of the qualified facility. However, physical work on a transformer that steps up the voltage of electricity produced at the facility to the voltage needed for transmission is physical work of a significant nature because power conditioning equipment is part of the qualified facility.

Likewise, the Q&A provides that roads on the site that are integral to the qualified facility are specified energy property, including onsite roads that are used for moving materials to be processed (e.g., biomass) and roads for equipment to operate and maintain the qualified facility. Thus, starting construction on these roads constitutes the beginning of construction. However, roads for access to the site, or roads used solely for employee or visitor vehicles are not specified energy property; starting construction on these roads is not starting physical work of a significant nature.

The Q&A also notes that because a building is not specified energy property, construction of a building is not physical work of a significant nature. However, the following structures are not treated as buildings for this purpose and may be considered specified energy property: (1) a structure that is essentially an item of machinery or equipment, or (2) a structure that houses property used as an integral part of a qualified activity if the use of the structure is so closely related to the use of the housed property that the structure clearly can be expected to be replaced when the property it initially houses is replaced.

Amount and Type of Physical Work Required. Consistent with answers provided by Treasury and Department of Energy officials at presentations on the cash grant program, the Q&A indicates that, in general, any physical work on the specified energy property will be treated as the beginning of construction even if such work relates only to a small part of the facility, such as laying the foundation for one wind turbine that is part of a larger wind farm.

However, in a similar context where a single foundation for one wind turbine that is part of a 50 turbine project is laid in 2010, but no other physical work on the wind farm takes place until 2012, the Q&A provides that Treasury will closely scrutinize any construction activity that does not involve a continuous program of construction or a contractual obligation to undertake and complete such

construction within a reasonable time. While the Q&A indicates that disruptions in the work schedule that are beyond the applicant's control (e.g., unusual weather or a site at which work can only be performed during certain seasons) will be taken into account in determining whether or not an applicant has undertaken a continuous program of construction, this requirement provides the exact sort of ambiguity that developers and investors had hoped that Treasury would eliminate. Importantly, if a project meets the 5% safe harbor test, the "continuous construction" requirement is inapplicable.

The Q&A also emphasizes that preliminary work such as clearing land and obtaining permits is not physical work of a significant nature on specified energy property, and erecting a fence (or beginning to erect a fence) is not the beginning of physical work of a significant nature because, generally, fencing is not an integral part of a qualified facility. Again, this focus within the Q&A on such specifics shows the importance of determining at the onset of a project what is and what is not specified energy property. Further, the Q&A provides that the removal of an existing facility to build a new facility is also considered preliminary work.

Binding Contracts. Both the Program Guidance and March 2010 revisions to such provided that for property that is manufactured, constructed, or produced for the applicant by another person under a written binding contract, the work performed under the contract is taken into account in determining when physical work of a significant nature begins. The Q&A further elaborates that work performed under the contract includes only work that takes place after the binding written contract is entered into. Moreover, the work is treated as physical work of a significant nature only if it is work on property that will become specified energy property of the applicant. For example, if a contractor is manufacturing wind turbines specifically for the applicant under a binding written contract, any physical work on those turbines is physical work of a significant nature on specified energy property of the applicant. If an applicant has a binding written contract with a contractor who is manufacturing wind turbines for a number of customers, physical work on the turbines would only be considered work performed under the applicant's binding written contract if the contractor can reasonably demonstrate that physical work has started on turbines that will become specified energy property of the applicant. The contractor may use any reasonable, consistent method to allocate work it performs among its customers. Whether a method is reasonable depends on all the relevant facts and circumstances.

However, the Q&A indicates that work performed under a contract does not include work to produce components or parts that are in existing inventory or are normally held in inventory by a manufacturer. Thus, physical work of a significant nature does not begin when an applicant merely purchases components or other parts from the inventory of a vendor under a binding written contract entered into before 2011.

Observation:

This requirement could potentially be troublesome if the applicant plans on meeting the "physical work of a significant nature" test solely with materials purchased from the manufacturer. For instance, solar panels are generally not specifically manufactured for a particular purchaser. If the applicant solely purchases solar panels from the manufacturer and the panels are either pulled from the manufacturer's inventory or if the manufacturer generally keeps an inventory of these types of panels, the purchase would not be considered for purposes of the meeting the test.

Notably, the Q&A provides that if the work performed otherwise meets the requirements for physical work of a significant nature and work on the project meets the "continuous construction" requirement described above, the fact that the specific site of the project has not been identified at the time of the initial application (or changes after the initial application) does not impact whether or not construction has begun.

Observation:

The physical work of a significant nature test is a very subjective test. As such, the applicant should only rely on this test if they are very confident the test is met. Otherwise, the applicant should instead rely on the 5% safe harbor set forth below.

5% Safe Harbor

Economic Performance Test. The Q&A indicates that although the specific reference to the Code Section 461(h) economic performance rules was deleted from the Program Guidance by the March 2010 revisions, the economic performance rules continue to apply in determining whether costs have been incurred. Why Treasury would delete such a specific reference to a well established tax concept only later to say that such rules still apply is unknown. Nonetheless, costs are thus taken into account when paid by cash-method taxpayers and when incurred by accrual-method taxpayers. Likewise, costs are paid or incurred by the person providing property to the applicant as that person pays or incurs costs in connection with providing property to the applicant. The Q&A further provides that property is provided to the applicant either when title to the property passes to the applicant or when it is delivered to or accepted by the applicant, depending on the applicant's method of accounting. Thus, if title to the specified energy property has passed to the applicant, the specified energy property can remain in storage at the manufacturer's site and still be considered provided to the applicant. In addition, property that the applicant reasonably expects to be provided within 3-1/2 months of the date of payment will be considered to be provided on the payment date.

Observation:

Query whether or not other evidences of ownership will be required in order for the purchaser of the specified energy property to be considered the owner (i.e., purchaser bears the risk of loss if the property is destroyed in a casualty at the storage site).

The Q&A goes on to provide that the 5% safe harbor contained in the Program Guidance includes a single exception to the general principles used to determine when amounts are incurred. Under general rules for property manufactured, constructed, or produced for the applicant by another (the supplier) under a binding written contract, the cost of such property is generally treated as incurred when the property is provided to the applicant. The Q&A indicates that for periods before the property is provided to the applicant, the exception allows costs incurred with respect to the property by the supplier to be treated as costs of the property that are incurred by the applicant when the costs are incurred by such supplier.

In determining what costs have been paid or incurred on its behalf by the supplier, the applicant may rely on a statement by such supplier as to the amount incurred by the supplier with respect to the property to be produced under the binding written contract. The supplier may use any reasonable, consistent method to allocate the costs incurred by it among the units of property. However, only costs incurred by the supplier after the binding written contract is entered may be allocated to the property produced under such contract. Moreover, while the economic performance rules also apply

to determine what costs have been incurred by the supplier, the exception described above does not. Thus, if components are manufactured for the supplier by a subcontractor, the cost of those components is incurred only when the components are provided to the supplier and not as the subcontractor pays or incurs the costs of manufacturing the components.

Observation:

This requires that not only applicants, but suppliers must understand how the rules under this and previous guidance operate in order to assist applicants.

5% of Actual Costs Must be Paid or Incurred. The Q&A specifies that to satisfy the 5% safe harbor, applicants must demonstrate that costs paid or incurred before the end of 2010 are equal to or greater than 5% of the total actual, rather than projected, costs of the specified energy property. However, the Q&A also provides that if the applicant's project includes multiple units of specified energy property, an applicant can opt to apply for a payment based on some, but not all, of such units.

But the example provided by Treasury to illustrate this concept creates more questions than answers. The example provides that if an applicant incurs $10,000 in costs in 2010 for specified energy property related to a 5 turbine wind farm anticipating total costs for the specified energy property of $500,000, but the actual total costs of the specified energy property amount to $600,000, the safe harbor would not be satisfied. Being that the 5% safe harbor is based on total project costs, the example is confusing because $10,000 would not meet the safe harbor threshold (i.e., $25,000 of $500,000) even if total project costs turned out to be $500,000. Hopefully Treasury will clarify this concept sooner rather than later due to the approaching end of the year deadline.

Observation:

In light of the 5% safe harbor being calculated on the actual cost of the project, the applicant should be conservative when modeling the cost of their project for purposes of meeting the safe harbor.

Master Contract Allocations. The Q&A confirms that costs paid or incurred by a developer under a master contract that are then allocated to an affiliated special purpose vehicle under a project contract can be treated as costs of the specified energy property, notwithstanding the substitution of a project contract for the master contract with respect to such property.

No Requirement that Construction Must be Continuous. Unlike the physical work of a significant nature test, there is no requirement that construction must be continuous if relying on the 5% safe harbor.

Observation:

Although the 5% safe harbor offers more clarity on when construction begins, if the applicant is relying on the work performed by the supplier in order to meet this test, establishing that the safe harbor is met in that situation could become very complicated.

Application Process Guidance

The Q&A reiterates that all applications must be submitted by the statutory deadline of October 1, 2011. For property that is placed in service before October 1, 2011, applicants need only submit a single application demonstrating both that construction began in 2009 or 2010 and that the property

has been placed in service. For property that is placed in service on or after October 1, 2011, applicants must submit a preliminary application by October 1, 2011, demonstrating that construction on the property began in 2009 or 2010. Such applications must then be supplemented at the time the property is placed in service. While Treasury cannot provide assurance that an applicant meets all the requirements for a payment until all facts and circumstances are known (i.e., at time the facility is placed in service), it will tell the applicant whether or not the work performed is physical work of a significant nature or, for applicants relying on the safe harbor, whether qualifying costs have been paid or incurred.

Physical Work of a Significant Nature Documentation. For projects relying on the physical work of a significant nature test, the Q&A indicates that applicants must document the physical work. To demonstrate that physical work of a significant nature has commenced at the site, applicants should submit a written report from the project engineer or installer, signed under penalties of perjury, describing the project's eligibility which includes a detailed construction schedule and estimated budget for the project, along with a description of the work that has commenced including any invoices for the work performed. For projects with an anticipated cost basis of $1 million or more, the report must be from an independent engineer.

To demonstrate that physical work of a significant nature has commenced under a binding written contract, applicants should submit a copy of the binding written contract and a statement from the contractor, signed under penalties of perjury, describing the work that has commenced and certifying that the work commenced pursuant to the binding written contract.

5% Safe Harbor Documentation. For projects relying on the 5% safe harbor, applicants must submit a statement from an authorized representative of the applicant signed under penalties of perjury, or for projects with an estimated eligible cost basis of $1 million or more, from an independent accountant, attesting to the method of accounting used by the applicant for federal tax purposes (i.e., cash or accrual).

For applicants that use the cash method of accounting, the statement should state (1) the amount that has been paid before the end of 2010; (2) a detailed description of the costs that have been paid, along with evidence of payment such as invoices or other financial records; and (3) an estimate of the total cost of the specified energy property.

For applicants that use the accrual method of accounting, the statement should state (1) the amount that has been incurred before the end of 2010; (2) a detailed description of the costs incurred, along with evidence of the costs incurred such as financial records; and (3) an estimate of the total cost of the specified energy property. If an applicant is relying on costs paid or incurred by a contractor, a copy of the binding written contract and a statement from the contractor, signed under penalty of perjury, of costs paid or incurred and allocated to applicant's project must be included.

Observation:

Note that a contractor must be very comfortable in its accounting conclusions as the statement is signed under penalty of perjury.

With the begin construction deadline approaching, the Q&A provides all project constituents with a better understanding of what must be done in order to qualify for the cash grant. Moreover, legislation has been proposed as part of the tax extenders bill to extend the cash grant program for an

additional 2 years, which would eliminate the need to begin construction before year end. Under the current form of such legislation, specified energy property will be eligible for the cash grant if the construction of such property begins by the end of 2012 and the property is placed in service before the end of the applicable credit expiration date (e.g., 2016 for solar). While the credit expiration date for wind facilities is also the end of 2012, such legislation would still remove the looming deadline to begin construction for such projects. We will keep you updated on this and any other developments regarding the cash grant program.

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