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Energy Update

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Renewable Energy Update:

Recent Treasury Guidance on the "Beginning of Construction" for the Section 1603 Cash Grant Program

On June 25, 2010, the U.S. Treasury Department released additional guidance in the form of 25 frequently asked questions and answers (FAQs) with respect to the "beginning of construction" requirement for renewable energy projects that may be eligible for a cash grant in lieu of an investment tax credit under section 1603 of the American Recovery and Reinvestment Act of 2009.

The new guidance is significant because of the impending deadlines for the cash grant program. To qualify for a grant, qualified energy property must be placed in service in 2009 or 2010 or, if construction begins in 2009 or 2010, it must be placed in service by the applicable credit termination date (currently the end of 2012 for wind; the end of 2013 for biomass, geothermal and other resources; and the end of 2016 for solar). It is currently uncertain whether Congress will extend the cash grant program to projects commenced after 2010. Extensions have been proposed by legislators, but the likelihood of passage this year remains unclear. Because of the deadline and the uncertainty surrounding extension, many project developers are likely interested in beginning construction this year on those projects that have a practical chance of meeting the requirements for commencement of construction before the end of 2010 in order to qualify for a cash grant to fund the development of the project.

The FAQs confirm that there are two ways to demonstrate that construction has begun on a project in 2009 or 2010: the first is to begin physical work of a significant nature, and the second is to meet a 5% safe harbor.

Physical Work of a Significant Nature

The FAQs confirm that any physical work that is started on the "specified energy property" is taken into account in determining if construction has begun, subject to certain limitations. The 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 of the qualified facility.

The FAQs draw a distinction between, on the one hand, roads on the site that are integral to the qualified facility, such as roads for equipment to operate and maintain the qualified facility or to be used for moving materials to be processed, which are considered specified energy property and can be considered in determining if construction has begun, and, on the other hand, roads that are not integral to the qualified facility, such as roads for access to the site or roads used solely for employee or visitor vehicles, which are not specified energy property and cannot be considered in determining if construction has begun. The FAQs note that fencing generally is not treated as an integral part

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of the qualified facility, and erecting a fence or beginning to erect a fence is not physical work of a significant nature constituting the beginning of construction.

The FAQs reiterate that preliminary work such as clearing land and obtaining permits is not physical work of a significant nature on the specified energy property. Further, the removal of existing facilities or demolition work does not constitute physical work of a significant nature on the specified energy property but rather is in the nature of preliminary work. The FAQs also state that the construction of a building at the site that will be used for operations and maintenance is not taken into account as physical work of a significant nature because a "building" is not tangible personal property or other tangible property and therefore does not qualify as specified energy property. On the other hand, a structure that is essentially an item of machinery or equipment (or is so closely associated with equipment as to constitute "other tangible property") does qualify. The FAQs also observe that property used for electrical transmission is not specified energy property. Thus, physical work on a transmission tower located at the site is not physical work of a significant nature on the specified energy property. However, work on property integral to the production of electricity, such as a transformer, does qualify. Finally, the FAQs state that test drilling for a geothermal deposit is a preliminary activity and is not considered physical work on specified energy property.

The FAQs clarify that "[i]n general any physical work on the specified energy property will be treated as the beginning of construction even if such work relates to only a small part of the facility." Treasury notes that it "will closely scrutinize any construction activity that does not involve a continuous program of construction or a contractual obligation to undertake and complete, within a reasonable time, a continuous program of construction." Thus, if an applicant is relying on the rule that physical work of a significant nature has begun by the end of 2010, it appears that the general expectation is that such work must continue without interruption. The 5% safe harbor discussed below differs on this point.

The FAQs confirm that any physical work of a significant nature performed under a binding written contract for the manufacture, construction or production of specified energy property may be taken into account, provided that the work takes place after the binding written contract is entered into and the property becomes specified energy property. A contractor may use any reasonable, consistent method to allocate work it performs for a number of customers among those customers. The FAQs further provide 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. The FAQs indicate that if physical work takes place pursuant to a binding contract, but the specific site or location of the project has not been determined prior to the deadline for submitting initial applications (October 1, 2011) or changes after an initial application is submitted, such uncertainty about the final site or such a change of site will not affect the determination of whether construction has begun.

5% Safe Harbor

An applicant meets the 5% safe harbor if the applicant pays or incurs 5% or more of the total cost of the specified energy property before the end of 2010. Costs are taken into account when cash-method taxpayers pay them and when accrual-method taxpayers incur them. The FAQs state that costs are incurred by accrual-method taxpayers when (1) the fact of the liability is fixed; (2) the amount of the liability is determinable with reasonable accuracy; and (3) the economic performance test set forth in the Treasury Regulation Section 1.461-4 has been met with respect to such cost. The FAQs confirm the economic performance principles set forth in IRC Section 461(h) continue to apply in determining whether costs have been incurred for purposes of the 5% safe harbor.

The FAQs indicate that, in the case of property manufactured for the applicant by another person pursuant to a binding contract, generally the economic performance test is satisfied when property is provided to the applicant.

Property is treated as 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. The FAQs confirm that 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 in accordance with Treasury Regulation Section 1.461-4(d)(6).

The FAQs explain that costs paid or incurred by a person providing property to the applicant are treated as being paid or incurred by the applicant even if the property has not been delivered to the applicant. This look-through rule does not apply twice to allow the applicant to be treated as having paid or incurred costs that have been paid or incurred by a subcontractor. An applicant may rely on a statement by a supplier as to the amount of costs incurred by the supplier with respect to the property to be manufactured, constructed or produced for the applicant under a binding written contract. The supplier may use any reasonable, consistent method to allocate the costs incurred by the supplier among the units of property to be manufactured, constructed or produced by the supplier.

The FAQs also provide some guidance for situations in which a developer assigns its contract rights to a special purpose vehicle that is the applicant for the grant. The FAQs indicate that the costs allocated to property under the original manufacturing contract are taken into account to the extent paid or incurred in 2009 or 2010, in determining if the substituted project contract entered into by the special purpose vehicle satisfies the 5% safe harbor.

The FAQs also confirm that the 5% safe harbor is measured by reference to the actual costs of the property, not the budgeted costs of the property. The FAQs provide that if an applicant's project includes multiple units of specified energy property, an applicant may opt to apply for a grant payment based on some, but not all, units of property. In addition, if an applicant meets the 5% safe harbor as of December 31, 2010, with respect to a facility, the applicant does not need to continue to work at the facility in 2011 in order to qualify for payment of a grant in 2012 when the facility is placed in service. Thus, the 5% safe harbor allows for an interruption in construction, which, as discussed above, is generally not expected to be allowed in the case of qualifying under the rule for physical work of a significant nature.

Process

The FAQs confirm that for projects placed in service after December 31, 2010, but before the statutory deadline of October 1, 2011, applicants need only submit a single application by October 1, 2011, demonstrating both that construction began on the property in 2009 or 2010 and that the property has been placed in service. For property that will be placed in service on or after October 1, 2011, applicants need to submit a preliminary application by October 1, 2011, demonstrating that construction began on the property in 2009 or 2010 and supplement that application when the property is placed in service. Applicants will receive a response to their applications telling them whether or not the work performed is physical work of a significant nature or, for applicants relying on the 5% safe harbor, whether qualifying costs have been paid or incurred.

The FAQs provide additional guidance on the types of documentation required to substantiate that physical work of a significant nature began before the end of 2010 or that 5% of the costs of the project were paid or incurred before the end of 2010. Depending on its particular situation, the applicant must submit a written report from the project engineer, installer, a representative of the applicant, and/or an independent accountant, signed under penalties of perjury, describing the project's eligibility for a grant. To meet the "physical work of a significant nature" requirement, the report should include the construction schedule for the project, the project's budget and a description of the work that has commenced including invoices for the work performed, as well as a copy of any binding written contracts for the work performed. To meet the 5% safe harbor, the statement should include: (1) a description of the costs paid or incurred before the end of 2010; (2) an estimate of the total costs of the project; and (3) invoices or other evidence that the costs have been paid or incurred before the end of 2010. Additional documentation may be required depending on the facts and circumstances, in which case applicants will be notified. ■

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