

Wind Industry Gets Instruction On Cash Grants

The Treasury has unveiled its guidelines, ending months of speculation from would-be applicants.

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Photo courtesy of Bruce MacGregor Photography

The U.S. Department of the Treasury has released its long-anticipated guidelines and application instructions for payments for renewable energy property under Section 1603, commonly known as cash grants.

The cash grants, which have been eagerly awaited since February's passage of the American Recovery and Reinvestment Act of 2009, will be given to wind developers who choose to forego all federal tax credits and instead receive a nontaxable cash grant from the U.S. government equal to 30% of the project's cost.

The Treasury also released its set of terms and conditions to which anyone receiving a grant will have to agree and the form that companies must complete to apply for a grant. The form is six pages long and requires a number of items to be attached to the application. It can be filed electronically.

Grants will be paid within 60 days after the later of when a complete application is received or the project is placed in service. The Treasury makes no discretion whether to pay grants; if a project qualifies, the owner is entitled to a grant. Congress provided an open-ended appropriation. The Treasury expects at least \$3 billion to be paid under the program and that more than 5,000 applications will be submitted.

Grants will be paid on equipment that uses wind to generate electricity and will fund 30% of most project costs. Grants will only be paid on new wind projects completed in 2009 or 2010, or that begin construction in 2009 or 2010 and are completed before the end of 2012.

When construction starts

Though the Treasury had five precedents from which to choose for when construction starts on a wind farm, it chose a definition at the early end of the spectrum. Broadly stated, construction starts when the developer accrues at least 5% of the total project cost. However, it is not enough

Cover Story

merely to have paid turbine vendor installment payments amounting to at least 5% of the project cost; the factory must have started manufacturing the equipment and reached at least that percentage completion.

The costs of land and preliminary activities that normally precede construction, such as engineering and design work, exploring for sites, researching the market and legal fees to negotiate financing, do not count and must be subtracted from both the numerator and the denominator of the fraction.

A developer that cannot meet the deadline may still be able to show that "physical work of a significant nature" began in 2010. However, the rules in this area are unclear. Any developer will be considered to have started physical work of a significant nature once work related to the excavation of the foundation, the setting of anchor bolts into the ground, or the pouring of concrete pads for the foundation begins. However, most developers hire third-party contractors.

If the contract is binding for tax purposes before the contractor starts work, then the key is to show that physical work of a significant nature began under the contract. The Treasury did not explain what that means. It appears that physical assembly at the factory under a turbine supply agreement qualifies, but only if the contract is clear about the quantity of turbines on order and the design specifications. If the parties make more than insubstantial changes to the contract later, then the cash grants do not apply.

Some developers are less concerned with whether they get work under way in 2010 than whether they did too much before 2009. If a project was under construction in 2008, then it must be completed in 2009 or 2010 to qualify for a grant.

The Treasury notes that it will treat each wind turbine, pad and tower as a separate facility, and treat the SCADA system, or the software and fiber-optic lines that collect data from turbines and help to regulate

them, as an independent property in its own right. However, companies can choose to treat "multiple units of property" that are located on the same site as a single project with a single start date. A project will be treated as though it were on a single site, even if it is a string of wind turbines spread over several adjoining parcels leased from separate landowners.

It does not matter if 90% of a project was completed in 2008. If the project is placed in service for the first time in 2009, then it qualifies for a full cash grant.

Lender issues

Banks have been reluctant to lend term debt to projects that receive cash grants for fear that a foreclosure on the project during the first five years will trigger recapture of the grant with the result that the government will take part of the collateral on which the bank is counting to help repay the loan.

The Treasury says there will be no recapture of cash grants, except in three circumstances:

- if there is a change in use of a facility during the first five years after the wind farm is placed in service;

- if the project is permanently shut down during the first five years, although there will not be recapture if the project is knocked out by a natural disaster, unless the owner rebuilds and claims a cash grant on the new equipment; and

- if the project or a partnership interest is transferred to a federal, state or local government agency or instrumentality, an entity exempted from taxes under section 501(c) of the U.S. tax code, an electric cooperative or Indian tribe.

Such a transfer would bring into play a provision in the stimulus bill that bars cash grants to projects with such persons as investors. The ban only applies if such an investor owns an interest in the project through pass-through entities like partnerships. It does not matter how small an interest such an entity owns or how far up it is in the ownership chain.

Other sales of projects will not trigger recapture, but the buyer must agree to be jointly liable for the recapture liability if it resells the project to a government or tax-exempt entity or electric coop.

For example, in cases where a project is owned originally by company A, but bank B takes the project in a foreclosure asset sale and B later resells the project to a state pension fund, the government can go after both A and B for the recapture liability. This requirement that the buyer must formally agree to exposure only comes into play when the buyer buys assets and not the project company.

The recapture liability will reside at the project company level. The government has no claim against the owners or anyone else who received the proceeds from the cash grant, unless the project is owned by a true partnership, as opposed to a limited liability company (LLC), in which case the government would also have a claim against the general partner.

The cash grant vests over five years. Any recapture would be only of the unvested grant. For example, a sale of the project to a tax-exempt entity in year four would subject 40% of the cash grant to recapture.

Any recapture liability will not be a tax claim. That means that the government will be an unsecured creditor. The government is not asking for a lien by contract as part of the terms and conditions that companies receiving grants must sign. It will get a lien eventually as a result of any judgment against the project company for the recapture liability, but any such judgment lien will be governed by state law and be subordinate to the liens of secured lenders.

Tax-equity transactions

There are two federal tax subsidies for renewable energy projects: tax credits and depreciation. Few U.S. developers can use them. Most have bartered the tax benefits in the past to large institutional investors

Cover Story

in exchange for capital to build their projects.

The tax-equity market ground to a halt late last year as the banks, investment banks and insurance companies ran out of tax base to use the tax benefits.

The depreciation can be carried forward for up to 20 years and used eventually to shelter future income from the project.

Many developers are still planning to enter into tax-equity transactions to get value for the “stranded” depreciation. There are three structures currently in use: partnership flip, sale-leasebacks and inverted leases. Before the stimulus bill was passed, leasing was not an option for financing wind farms.

A sale-leaseback transaction may be attractive to some developers, because it offers full funding for the project. It also lets the lessor claim 100% of the tax depreciation, while it may be difficult to transfer the full depreciation to an investor in a partnership flip transaction.

Close to 50% of the project cost can be raised from a tax-equity investor in a partnership flip in the current market, but that counts the 30% Treasury cash grant as part of the 50%. The tax-equity investor funds roughly half the project cost at the end of construction. When the cash grant is paid 60 or more days later, the partnership distributes it to the tax-equity investor. Thus, something like 19% of the project cost might be raised against the depreciation.

Most tax-equity investors have worried that they need to come into the partnership flip before the first turbine is placed in service. The fear was that a sale of the project or an interest in the project after it goes into service would trigger recapture of a cash grant. Tax-equity investors have been talking about funding before the first in-service date anywhere from 5% to 30% of the total amount they plan to contribute and funding the rest after the project is completed.

An investor may still want to invest early in deals in which the par-

ties plan to claim a depreciation bonus. The bonus is a limited-time offer by the U.S. government to spur new investment in 2009 and 2010, while the economy is weak.

Half the cost of new equipment can be deducted immediately. The other half is depreciated normally. The accelerated depreciation is worth roughly \$0.019 on the dollar of capital cost in the typical wind farm or solar project. As a practical matter, the depreciation is available on most renewable energy projects only if placed in service in 2009. Perhaps counter-intuitively, some tax-equity investors prefer not to take the bonus.

A tax-equity investor cannot ordinarily share in the full bonus unless it is a partner before the assets on which the bonus will be claimed go into service. If it comes in later that same year, then the bonus that year is split between the developer and the partnership in the ratio of the number of months each held the asset during the year, starting with the month the asset went into service.

There is an exception in cases where the investor comes into an existing partnership the same year in a manner that causes the partnership to terminate for tax purposes. In that case, the full bonus can be claimed by persons who are partners after the termination.

A tax-equity investor may have other reasons to come in early, depending on the transaction. By coming in early, it may be possible to step up the tax basis of the partnership to full fair market value, allowing for a larger cash grant, in some cases. There may be a reason, in some deals having to do with how partner capital accounts are calculated, to have the investor come in early.

Most projects are owned by LLCs. Thus, the grant will be paid to the LLC. It does not matter how the LLC is treated for tax purposes.

If the project is sold and leased back within three months after it is originally put into service, then the grant will be paid to the lessor, unless it elects to leave the grant with the lessee. The les-

sor calculates the grant on its tax basis in the property. That is the amount the lessor pays to purchase the project, even if it reflects a markup from the amount the developer-lessee paid to build the project.

Some developers have been enamored lately with an inverted pass-through lease structure where the developer leases the project to a tax-equity investor, who sells the electricity and turns over most of the revenue to the lessor as rent. When the lease ends, the developer takes back the project for free. The developer elects to leave the cash grant with the lessee. The Treasury will allow pass-through lease structures to apply for cash grants.

The lessee calculates the grant on the fair market value of the project rather than what it may have spent to build it. It must report half the grant as income on a straight-line basis over five years.

Private equity

Developers that are partnerships for tax purposes and have private equity funds as investors will not be able to claim cash grants on their projects, unless the project company is turned into a corporation for tax purposes or the private equity fund inserts a “blocker corporation” between it and the project.

The economic stimulus bill barred any cash grant from being paid on projects that are owned by partnerships or other pass-through entities if any of the investors is a state pension fund, university endowment or similar entity. Most private equity funds have such entities as investors.

The staffs of the tax-writing committees in Congress have said they wrote the provision more broadly than intended. There is a good chance Congress will scale back the ban, but not until late in the year. The staffs are considering a technical correction that would make clear that investors are not considered tax-exempt entities for purposes of the ban if they pay taxes on their earnings from the projects as “unrelated business taxable

Cover Story

income.” With the lone exception of state pension funds, most investors pay taxes on earnings as unrelated business taxable income.

It was unclear whether a blocker corporation might itself be treated as tax exempt if it is owned 50% or more by tax-exempt entities. The guidance made it clear that this is not a problem.

Some developers who put projects in service early in 2009 have made retroactive elections to treat the project companies as corporations for tax purposes in order to shield the projects from the cash-grant ban. Such elections can be made up to 75 days in the past. The question, in such cases, is whether the elections were made in time to take effect before all of the turbines, solar panels or other equipment went into service.

The guidance helps in such situations. The developer can elect to treat all the turbines placed in service in 2009 at a wind farm, for example, as having a single in-service date – the date that the project went into service. This has the effect of buying more time to put a blocker in place.

A developer may not have the final cost figures until some time after a project is completed. In such cases, it would probably be best to apply with what the developer has and then amend the form before the grant is paid. There is no formal process to apply for an additional payment later, when additional costs come in, but Treasury officials suggest that another form might be filed to supplement the original one in cases where a grant has already been paid.

Projects that are merely under construction in 2010 must apply in 2011, whether or not they are completed then. All applications under the program must be in by September 2011 so that the government has a sense for what it might still have to spend under the program.

The government will review 2011 applications and let the developer know that the project will qualify

for a grant based on the information received so far. The developer must then complete the rest of the form within 90 days after the project goes into service.

Once an application is approved, the Treasury will inform the company. The money will be wired within five days.

The applicant must submit the signed terms and conditions at the same time it applies for the grant.

Several other documents, such as the power purchase agreement, must be submitted with the form.

The longest lead-time item is probably a cost breakdown showing how the applicant arrived at the “tax basis” on which it is calculating the

also provide proof that the project is interconnected and supplying electricity to the grid.

Anyone applying in 2011 for a project that is still under construction must submit proof that construction got under way in 2009 or 2010. That might be invoices marked “paid” for at least 5% of the expected project cost plus proof from the vendor about the percentage of construction that was completed.

The Treasury is expected to disclose publicly who applied for grants and the amount of grant paid.

Companies receiving grants will have to report annually to the Treasury for five years on how the project is doing. The reports are due 21

Projects under construction in 2010 must apply in 2011, regardless of completion.

cash grant. Only part of the equipment at a project may qualify for the grant. An independent accountant will have to certify the cost figures and how they have been allocated.

The government has been concerned about fraud. It toyed with the idea of asking state government officials to visit sites to confirm that projects that have applied for grants exist, but gave up on the idea because it would take state governments too long to mobilize.

The applicant will have to provide a certificate confirming that the project was put in service from a project engineer, equipment vendor or an independent third party. The Treasury has in mind the same certificate that is normally given to lenders or a tax-equity investor at funding by an engineer who inspects the project and attests that certain conditions to funding have been satisfied. The Treasury is not looking for a new piece of paper created for the grant application.

Projects that sell their electricity to utilities and have interconnection agreements with the utilities must

days after each anniversary of when the project was placed in service. The report must indicate who owns the project, the installed capacity, annual output and the number of jobs retained.

Applicants must get a DUNS number from Dun & Bradstreet either by Internet (<http://fedgov.dnb.com/webform>) or by calling 1-866-705-5711. The number is assigned at the end of the call. It takes roughly five minutes. Then, the applicant must wait about two days to register on the Central Contractor Registration site (www.ccr.gov/startregistration.aspx). That process also is easy and requires filling out a form online. Both registrations are free.

Other issues

A company can directly assign the right to its grant to a lender or a tax-equity investor. An overt assignment to a tax-equity investor could have unfavorable tax consequences, depending on the form of the tax-equity transaction.

Anyone making capital improvements in 2009 or 2010 to an existing

Cover Story

power plant that uses wind power will be able to receive a cash grant on the improvements. The IRS uses an 80-20 test to determine whether improvements were extensive enough. These improvements describe the amount the company spends on upgrading the plant is at least four times the value of the existing equipment retained from the old plant. Wind projects owned by regulated utilities will not qualify for cash grants unless the utility uses a normalization method of accounting.

The Treasury says that grants can be claimed on roads and paved parking areas that are used in connection with moving biomass or other fuel or equipment needed to operate and maintain a plant. These are considered integral to generating electricity

at a plant. However, a grant cannot be claimed on roads and parking areas that are used solely by employees or visitors.

The grant applications must be signed under penalties of perjury. Since the grants are not a tax program, if the applicant is found to have claimed too large a grant, he will be dealing with the U.S. attorney. There are gray areas about the scope of eligible property, placed-in-service determinations, what costs are properly capitalized into what assets, when construction is considered to have commenced, and similar issues where well-meaning and reasonable people may disagree.

With a tax program, one can apply to the IRS for a private letter ruling. These usually take four to six months and are expensive.

The Treasury has tried to set up a more streamlined process. Questions can be sent by e-mail to 1603Questions@do.treas.gov. This may offer a means to get relatively quick answers even to tax-related questions. The application is no different than the tax returns companies already file and on which they take positions while attesting to the accuracy on the return. **VP**

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