

Section 1603 Update

by Keith Martin, in Washington

Many US developers are rushing to start construction of renewable energy projects before year end so that the projects will qualify for so-called section 1603 payments from the US Treasury. The payments are normally 30% of the project cost.

Their strategies often involve taking delivery of equipment that will be used in the projects.

They may not know yet where the equipment will be deployed.

These developers will have to be careful next year when transferring the equipment or interests in the projects while the projects are still under construction. The ability to claim a Treasury cash grant may be lost.

The Treasury has made clear where lines are drawn in a series of meetings, telephone calls and emails in recent weeks.

In other developments, the Internal Revenue Service released an internal memo in October that claims the agency can audit cash grants that have already been paid on projects. The memo has not gone down well with some parts of the wind and solar industries.

The Treasury said on June 30 that it used a benchmark of \$4 to \$7 a watt for judging whether solar developers were claiming too high a value for projects put in service in the first quarter this year. Solar module prices have been falling since then.

An inspector general report posted to the Treasury website in mid-October about a grant paid on a large wind farm suggests the Treasury will pay grants on spare parts stockpiled to prevent downtime at projects in remote areas. The Treasury released five inspector general reports in October asking two wind companies and one solar developer to repay part of the grants that they received on five projects. The largest repayment claim is \$2.1 million against a grant of \$67.9 million

Construction-Start Issues

All remaining wind, solar, geothermal, fuel cell and other renewable energy projects must be under construction by the end of this year to receive a Treasury cash grant.

There are two ways to start construction. One is to take delivery of enough turbines, solar modules or other equipment this year to amount to more than 5% of the project cost. The

other is to start physical work of a significant nature. Lenders and tax equity investors have shown a clear preference for the 5% test. The problem with the physical work test is that it does not require as much effort this year, so the Treasury requires the developer be able to show there was continuous construction after 2011. Many lenders and tax equity investors do not want to take the risk.

It is not enough for a developer trying to start construction under the 5% test merely to spend money in 2011. It must "incur" costs in 2011. That usually means take delivery of equipment, with one exception. The developer can pay for the equipment this year and count the spending as 2011 costs, provided it takes delivery within 3 1/2 months after payment. The payment must be for the specific equipment delivered and not a general milestone payment.

The Treasury has said a wind or solar company that takes delivery of a large number of turbines, solar modules or inverters this year, without knowing where the equipment will be used ultimately, can contribute batches of such equipment after this year to separate project companies and in that way seed multiple grandfathered projects. Enough 2011 equipment must be put in each project company to amount to more than 5% of the project cost.

Treasury has wavered whether the test is more than 5% of project cost or the amount the developer ultimately uses as its basis to calculate its grant on a project. Grants are normally 30% of the project cost. However, in some cases, grants are calculated on the fair market value after construction rather than the project cost. In such cases, 5% may be on the higher number.

Investors buying into a project or lenders foreclosing on a project after this year while the project is still under construction must be careful.

The ability to claim a Treasury cash grant will be lost if equipment or other project assets are transferred directly. Grandfather rights to a grant do not carry over in an asset transfer while a project is still under construction.

They carry over only if the investor or / continued page 2

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lender buys or forecloses on the project company — not the assets.

The Treasury does not want trafficking next year in grandfathered equipment. Some entrepreneurs have talked about stockpiling components, particularly in the solar market, and then selling them next year as “golden” inventory that will entitle the holder to a cash grant. This does not work. The Treasury is expected to be on the lookout for schemes where stockpiled inventory is dropped into special-purpose project companies and the project companies are sold as a way of selling inventory.

Any transfer of assets after this year potentially raises issues. However, a capital contribution by a developer to a limited liability company that the developer continues to own is not a problem. Treasury has also said that a normal tax equity transaction is not a problem — for example, where assets are sold and leased back within three months after a project is placed in service or an investor is brought into a project company that owns the project as a partner with the developer.

IRS Audits

The Internal Revenue Service released an internal memo in early October that suggests the IRS can audit cash grants on projects. The memo came as a surprise and has led to protests from some parts of the wind and solar industries.

Some forms of tax equity transactions allow grants to be calculated on the fair market value of the projects after construction rather than the construction cost.

The Treasury has sometimes pushed back on the values claimed, particularly in leasing transactions.

Developers have argued in meetings with the Treasury that the IRS would accept the values claimed in such transactions if an investment tax credit were claimed in place of a Treasury cash grant. They have appraisals to back up the values claimed. In addition, where the tax equity transaction is a sale-lease-back, the value claimed was actually paid by a tax equity investor to buy the project.

The Treasury often responds that the developer is free to claim an investment credit instead of a grant and deal with the IRS. However, it also points out that one benefit of the grant program is that any issues are worked out at inception before the grant is paid. With the IRS, it can be three years or more before issues come up on audit.

The IRS memo suggests companies receiving grants may end up running the gauntlet twice — once with the Treasury

and again with the IRS.

The memo is from the IRS national office to the part of the IRS that audits tax returns.

It says three things.

If an IRS agent finds a grant was overpaid, then the recipient must report the overpayment as income in the year the grant was received. The memo gives two examples where this might occur. One is where the IRS finds that a project went into service too early to qualify for a grant. Grants were not paid on projects before 2009. The other is where the grant is passed through to a lessee, and the IRS decides the lessee claimed too high a market value. (Some projects, particularly in the solar rooftop market, are financed by leasing the project to a tax equity investor who prepays part of the rent for use of the project. The developer elects to “pass through” the grant to the lessee. Treasury rules allow the grant to be calculated in that case on the fair market value of the project.)

Second, the memo said that the grant recipient can deduct any amount it repays the Treasury in the year the grant is repaid.

Finally, the memo said that the grant recipient can increase its basis for depreciation by half the overpayment. (If the recipient was a lessee in an inverted lease, then it has an additional deduction to the extent it reported too much income. A lessee must report half the grant as income ratably over five years.)

Congressional sources say that they thought the IRS had authority all along to audit grants. The program was originally conceived as a spending program that would be run by the US Department of Energy, but renewable energy companies pushed during debate to have it moved to the Treasury as they had more confidence in the Treasury to implement the program quickly.

The Treasury had doubts and asked Congress to clarify the IRS audit authority in a technical corrections bill in late 2009. The bill was never enacted.

The section of the economic stimulus bill that created the grant program in 2009 directed the “Secretary of the Treasury” to implement the program. The same words are used in the US tax code to mean the IRS. However, Treasury interpreted the authority to reside in the office of the fiscal assistant secretary because the grant provisions were not put in the US tax code. The Treasury view appeared to be that the IRS had no authority over the program. The same IRS branch that wrote the internal memo helped the Treasury with rules to implement the program, but it has declined to issue private rulings on grant issues as it would if investment tax / *continued page 3*

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credits were involved.

On one and perhaps two occasions, the Treasury has paid a grant a company requested but made it sign an agreement giving the IRS authority to audit later.

Solar Benchmarks

The US Treasury said in a posting to its website on June 30 that it expects to pay cash grants on solar photovoltaic projects of roughly \$7 a watt on residential installations of less than 10 kilowatts in size, around \$6 a watt on installations of 10 to 100 kilowatts, around \$5 a watt on installations of 100 kilowatts to 1 megawatt, and around \$4 a watt on larger projects.

These are benchmarks for solar equipment put into service during the first quarter of 2011.

Companies that claim a “materially higher” tax basis can expect more questions about their applications.

The Treasury also explained its approach for evaluating the tax bases that companies are using to calculate cash grants.

The financing structures used by many developers allow them to claim cash grants on the fair market value of projects rather than their cost.

The Treasury said it will accept three methods to arrive at fair market value, but that the cost approach, where it starts with a detailed list of costs incurred by the developer and then adds a markup or developer fee, is the “most concrete and supportable analysis and is favored by the review team.” It said “appropriate markups typically fall in the range of 10 to 20 percent” with the actual amount tied to the amount of activity, capital and risk for which the developer is being compensated.

It said comparable sales data is also acceptable, but the data must be adjusted to account for any ineligible assets that were transferred as part of the project to a tax equity investor. Examples of ineligible assets include power contracts and security fences. Grants are paid only on equipment.

It said that the income approach to arrive at value is the “least reliable method” because of the large number of variables that are “subject to speculation and open to debate.” It said any appraisals submitted that use the income method should be sure to allocate value between eligible and ineligible assets.

Inspector General

The Treasury released five reports in mid-October on inspector general audits of two wind companies and one solar

company that received Treasury cash grants. The inspector general asked the companies to repay amounts ranging from several hundred dollars to \$2.1 million.

Two of the reports involved two wind farms that E.On Climate and Renewables North America built in Texas. The projects are the 197-megawatt Inadale wind farm and the 249-megawatt Pyron wind farm.

E.On received a grant of \$121.9 million on Pryon in September 2009 just eight days after applying. It received a grant of \$94.2 million on Inadale in January 2010 27 days after applying.

The inspector general questioned whether the company was entitled to grants on roughly \$3.5 million that the company paid for spare parts for the two projects.

Normally, grants are not paid until equipment is put into service.

Spare parts are not usually in service until they are installed. However, “emergency spares” that a company needs on hand to prevent operational downtime are considered in service even though they are not yet in use. In a sense, all spares prevent operational downtime, so there normally must be a strong back story. In this case, E.On argued that its wind farms are in remote locations making it time consuming to bring parts to the site. After conferring with the Treasury cash grant program office, the inspector general decided that E.On was right.

However, it asked for \$611 back that it said was overpaid on the Inadale project. E.On had claimed a grant on a \$2,038 cost item described as “Balance to Tie.” The inspector general said the company was unable to provide supporting documentation.

The other three inspector general reports involve grants paid to Acciona and eSolar.

The inspector general took issue with \$117,497 in costs out of \$19.5 million claimed on a five-megawatt solar thermal facility that eSolar built in Lancaster, California. The company applied for a Treasury cash grant on the project in September 2009 and was paid the grant in late February 2010. In November 2009 while the grant application was pending, it settled a claim against a contractor, which reduced the cost of the project by \$80,285, but it did not update its grant application. The developer did not dispute the inspector general report, but said it has accrued other costs exceeding the adjustments since the grant application went in. If the company spent more on new capital improvements, it may qualify for an additional grant. However, the

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amounts must be new spending after the original application was filed. The Treasury will not pay an additional grant on costs that could have been included in the original application.

Turning to Acciona, the inspector general said Acciona should repay \$2.1 million of a \$67.9 million grant the company received on its EcoGrove wind farm in Illinois. The inspector general said the company should not have claimed a grant on \$5.3 million in interest charges that one Acciona entity that owned the project paid another Acciona entity that supplied the turbines for a delay in paying for the turbines. The inspector general said roughly 40% of the interest claimed by Acciona supposedly accrued before the turbine supply agreement was signed. The inspector general also denied another \$831,160 in costs for an “extended warranty” on the turbines. The Treasury does not allow grants to be claimed on the costs

of extended warranties.

Unlike the other developers who agreed to repay the Treasury, Acciona said it does not agree with the conclusions. The Treasury cash grant team told the inspector general that it needs more time to evaluate Acciona’s arguments before deciding the company should repay the money.

In the last of the five reports, also relating to Acciona, the inspector general asked for \$7,277 back out of a \$2.9 million grant paid on the Nevada One solar thermal project. Acciona said it was willing to adjust, but had other costs that exceeded the adjustment on which it could ask for a grant.

The inspector general staff did not appear, as of late September, to be doing any additional field work. It is unclear how many more reports might still be issued based on past visits to other grant recipients. The other visits may not have led to any adjustments. ©

November 2011