

U.S. TREASURY TACKLES INFLATED SOLAR CASH GRANT APPLICATIONS

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PART I

Overview

The U.S. Department of Treasury recently released formal guidance on how much it expects to pay on cash grant applications for solar photovoltaic projects. The guidance specifies benchmark prices for solar PV projects that range from \$7 per watt for residential solar systems to \$4 per watt for large utility-scale solar systems, and threatens to "closely scrutinize" applications that claim a grant on value that is "materially higher" than its benchmark price.

The guidance also identifies certain applications that will draw a closer look from Treasury's review team, including those with "related party considerations," such as developer markups, sale-leaseback transactions or other "unusual circumstances," where the claimed grant amount is influenced by other factors, like a valuable power sales contract.

Owners of solar projects that claim a grant that is inflated by a developer mark-up, may now have to substantiate this claim by showing that the markup "is consistent with industry standards and with the scope of work for which the markup is received." The guidance says that Treasury's review team believes that a developer markup should "typically fall in the range of 10-20%."

The guidance describes what many in the industry have long suspected: there is a two-track process for approving cash grant applications. The first track applies to applications where the claimed basis is consistent with or less than benchmarked prices. The review of these applications focuses on whether all claimed costs are in fact eligible for a cash grant. The second track is for applications that claim a basis higher than benchmarked prices, where the review seeks to determine whether the claimed basis is consistent with the property's fair value and whether some of the claimed basis should

properly be allocable to costs that do not qualify for the cash grant.

This guidance has ramifications well beyond just cash grant applications for solar photovoltaic projects because its methodologies are expressly made applicable to all cash grant applications.

30% of What Number?

The cash grant program was signed into law in February 2009, and generally provides that owners of solar systems are eligible to receive up to 30% of the "basis" of their property in the form of a cash grant from the Treasury, as long as certain proscribed deadlines are met. Treasury guidance issued in July 2009 clarified many of the details relating to this subsidy, including which specific components of a solar system are eligible for the cash grant and how "basis" should be computed. On the question of basis, the Treasury guidance defers to the tax rules, stating that "The basis of property is determined in accordance with the general rules for determining the basis of property for federal income tax purposes. Thus, the basis of property generally is its cost (IRC section 1012), unreduced by any other adjustment to basis, such as that for depreciation..."

Calculating Tax Basis

Since its inception, the cash grant program has struggled with the burden of being a cash-based program that is governed by federal income tax principles that oftentimes are difficult to apply or justify. The basis rules that lie at the heart of this program provide a good illustration of this struggle.

The cash grant is applied for and claimed by the legal entity that owns the solar project. In many cases, the legal entity that applies for the cash grant is a limited liability company that is formed by a developer to develop and operate the solar system. The ownership interests of this entity are held by the project developer. Under the tax rules, a limited liability company that is owned entirely by one person is called a "disregarded entity," meaning the tax rules do not recognize it as a separate taxpayer.

Most project companies that apply for a cash grant have no actual basis in the solar project for which they are claiming a cash grant. Solar projects that are owned by a disregarded entity are considered to be owned entirely by the owner of the disregarded entity, with the result that the owner, or developer, is the one that has a basis in the solar project.

Because it is most typically the owner of the applicant that has the "basis" in the solar equipment, a sale from one owner to another, or fees paid by the system owner to another person to develop the project may well affect the amount of basis on which the cash grant is claimed. In a simple example, if a developer builds a solar project for \$100 and then sells it for \$200, the buyer's basis should be \$200, and the cash grant may well be \$60 (30% of \$200).

Basis is generally the price paid to buy or build the solar project. If you pay \$100 for a solar project, your basis is \$100. If you then sell the same solar project to someone else for \$200, the new buyer's basis is \$200, the price the buyer paid to buy the asset. The "cost" of the buyer getting a higher basis is generally that the seller will have to pay tax on the \$200 minus the amount of basis it had before the sale (\$100).

In most cases outside of the world of cash grants, the tax paid by the seller on the \$100 will outweigh any benefit gained by the buyer in obtaining a basis that is \$100 higher than the seller's.

PART II

Structuring to Increase Basis

Perhaps the most direct way to structure a project for the maximum eligible grant is to lease the solar project to a lessee and avoid the basis rules altogether. A lessee of a solar project may claim the cash grant on 30% of the fair market value of the solar system, no matter what the actual basis is at that point in time. Financing structures that take advantage of the lessee claiming the cash grant are referred to as "pass-through lease structures," because the owner of the project "passes-through" the rights to the cash grant to the lessee under the lease agreement.

This rule can be extremely beneficial because it allows for an increased basis without the usual tax cost of a sale that usually accompanies a basis increase.

Treasury's guidance extends to lease pass-through transactions as well, stating that "An evaluation of the property's fair market value is also relevant in the context of applications by lessees of leased property, where the applicant has chosen fair market value as the basis."

In all other transactions aside from pass-through leases the cash grant program pays as a percentage of basis, and thereby incentivizes applicants to structure transactions that achieve the highest possible basis.

A cash grant payment equal to 30% of any incremental increase in basis typically far outweighs the tax consequences of achieving this higher basis.

Two simple examples illustrate this point.

The first is where an entity owned by a developer charges a "fee" for providing something of value to another entity that will develop and own the solar system. As long as the two entities are separate "tax" entities (meaning none of them is a disregarded entity), the entity that pays the fee should get an increased basis in its project and the entity that receives the fee would owe tax on the payment. A second example is where a developer sells the solar system at a profit to a buyer that claims the cash grant based on the price it paid. Again, so long as the seller and buyer are both tax entities, the seller pays tax on its profit and the buyer claims a basis equal to its purchase price.

The after-tax economics of structuring for an increased basis are almost always beneficial in the context of a solar project that qualifies for the cash grant. Any increase in basis is almost immediately rewarded with an increased grant equal to 30% tax free as well as additional basis that allows for future tax deductions as this basis is written off in the future. Owners of solar projects can generally deduct this additional basis over five years. The corresponding payments that create this basis are taxed at the seller's tax rate which is usually no higher than 35% and can often be offset by other tax deductions or losses available to the seller.

How The Guidance Deals With This Problem

One of the main thrusts of the guidance is the principle that the Treasury is not required to include a payment in basis just because it has actually been made. Consistent with a number of court cases that have evaluated basis in the tax credit area, the Treasury states that when "a taxpayer's stated cost for an asset does not reflect the true economic cost of that asset", it will not permit these costs to be included in basis.

The guidance highlights the two most common reasons why the Treasury might challenge a payment as not includible in basis: The payment is part of a transaction that is not conducted at arm's length, or there are "peculiar circumstances" that serve to inflate value.

The problem transactions that are the focus of the guidance generally involve related persons (developer selling or paying a fee to an affiliate) or sales of solar systems that come together with valuable contract rights.

A sale of a solar project, unless it is at a very early stage, usually involves the sale of all the project contracts that have been secured by the seller. Depending on how far along in the development process the project is, these will typically involve a power purchase agreement, various land leases and also permits and other interconnection rights. If any of these contracts are "out of market," meaning they were obtained under favorable terms, some of the sales price may need to be attributed to these contracts. In most cases, the sales price paid for contracts is not eligible for the cash grant.

Valuing contracts independent of the solar system on which the contracts are dependent is a difficult exercise, however, and one hopes the Treasury applies this rule sparingly and only in clearly abusive cases where assets trade hands at prices far in excess of their values.

The other type of problematic transaction is where the buyer and seller are related to one another. The extra focus on these transactions is clearly warranted as there is no outside "check" on the prices that can be charged. Sales in which there is not full overlap of ownership among the buyer and seller should present a strong defense to a Treasury challenge, particularly in those circumstances where someone unrelated to the

buyer or seller shares meaningfully in the sales proceeds.

Somewhat mysteriously, Treasury chose to include sale-leasebacks as suspect transactions. In a typical sale-leaseback transaction, a solar developer sells his project to a bank and then leases it back in exchange for rent payments under a lease. These transactions present much less room for abuse because the bank that buys the project carefully negotiates the sales price to ensure that the project will be profitable enough to support the rent payments under the lease.

Life After the Guidance

The guidance provides some "pointers" to owners of solar systems who may have fact patterns that will relegate them to the dreaded "close scrutiny" line. As a preliminary matter, any markup or increase above cost should be supported by an independent appraisal. The appraiser should use a "bottom up" cost approach, starting with the manufacturer's cost and should specifically evaluate the markup and benchmark it against other market comparables for similar solar projects. Where the project differs from a typical solar project, either because of its physical characteristics, geographical location, or technological specifications, those differences should be carefully highlighted and evaluated by the appraiser.

The appraiser should also support the value of the solar system through the use of the discounted cash flow approach. Any discounted cash flow analysis however, should pay careful attention to justifying the discount rate used and should be cautious about including speculative revenue, such as uncontracted solar renewable energy credits, into the financial model without a deep discount that adequately reflects the risks of receiving these revenue streams.

The Treasury guidance should not spell the end of related party sales, developer fees or sale-leaseback transactions in the solar market. It simply means that Treasury intends to bring a more watchful eye to this area. Owners of solar projects applying for the cash grant must now be far more disciplined and thorough when structuring transactions with any of these features.