

More Subsidies for US Energy Projects

by Keith Martin and John Marciano, in Washington

Congress gave developers of US renewable energy projects in late December another year through December 2011 to get new projects under construction to qualify for cash grants from the US Treasury for 30% of the project cost.

The fact that Congress waited until almost the end of 2010 to let developers know they have more time—the extension became official on December 17—made for a rush by developers to order equipment and get work under way at factories and project sites. The experience provided some useful practical lessons for what to do or not to do when a similar rush is expected in late 2011.

The same bill that extended the deadline for cash grants also authorized a 100% “depreciation bonus” on new equipment put into service after September 8, 2010 through December 2011 or 2012, depending on the project. The bonus is a timing benefit. Instead of depreciating a project over the normal depreciation period, the entire cost can be deducted in the year the project goes into service.

However, projects on which work started before 2008 may not qualify.

Many developers are expected to have trouble using the bonus. There was already a 50% bonus during 2010, but many tax equity investors made developers opt out of the bonus because the investors were trying to conserve tax capacity to spread over a larger number of deals.

A 100% depreciation bonus is worth roughly 4.45¢ per dollar of capital cost in additional subsidy on a wind, solar, geothermal or fuel cell project. It is worth more on other renewable energy projects and as much as 18¢ per dollar of capital cost on some transmission lines, power plants that use fossil fuels and some parts of certain biomass plants.

Congress made other changes that will affect other parts of the project finance market in the same bill in late December.

Section 1603 Payments

In early 2009, Congress directed the US Treasury Department to pay owners of new renewable energy projects that are completed in 2009 or 2010, or that start construction in

2009 or 2010, 30% of the project cost in cash as an economic stimulus measure. The grants are sometimes referred to as the “section 1603 program.” Developers receiving grants must agree to forego tax credits that they would otherwise have received on the projects.

The program paid \$5.8 billion through the end of 2010. The three largest Treasury cash grants to date are \$276 million paid on the Meadow Lake wind farm in Indiana, \$222.9 million for the Penascal wind farm in Texas and \$218.5 million for the Windy Flats wind farm in Washington state.

It looked during most of 2010 that if the program were extended, it would be turned into a tax refund program in which the government would pretend that a project owner overpaid its income taxes by 30% of the project cost in the year the project is completed. The owner could then apply for the taxes back. This would have delayed grant payments compared to the current program and might have shifted administration of the program to the Internal Revenue Service.

In the end, Congress simply changed a date.

Grants will now be paid on projects that are completed or that start construction in 2009, 2010 or 2011.

Projects that merely start construction must be completed by a deadline.

The completion deadlines have not changed. They remain 2012 for wind farms, 2016 for solar and fuel cell projects, and 2013 for most other projects.

Grants are paid on equipment that uses wind, sunlight, geothermal steam or fluid, biomass, municipal solid waste, landfill gas and, in some instances, water to generate electricity. They are also paid on fuel cells, combined heat and power projects (or what used to be called cogeneration facilities) of up to 50 megawatts in size, gas micro-turbines and geothermal wells and pipes. The grants on small cogeneration facilities and gas micro-turbines are only 10% of the project cost. The deadline to put them in service is 2016. The Treasury is not sure it will pay grants on geothermal wells and pipes that are put in service to serve an existing / continued page 2

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power plant.

Developers should not assume that the cash grant program will be extended again by Congress. Republicans are now in control in the House and have more seats in the Senate. The Republican counsels to the House and Senate tax committees said at a wind industry forum in late November that their party is opposed to extending the program. They see it as part of the Obama stimulus measures against which the party voted *en masse*.

Practical Lessons

The fact that Congress waited until the last minute to extend the construction-start deadline acted as a stimulus as developers rushed to order equipment and start work at factories and on project sites before year end.

There are two key takeaways from that experience. Some important practical information also came out during discussions with the Treasury late in the year as the deadline was approaching.

Start planning early in 2011 how to start construction by year end. Developers who waited until the fall 2010 to start planning found equipment manufacturers had already committed their production slots to others who had gotten in line earlier.

It is better to try to incur more than 5% of the total project cost by year end than to rely solely on starting physical work at the site or a factory. Tax equity investors and lenders proved unwilling in some cases to assume that a project got underway in time if all the developer could point to was physical work at the site. Anyone relying solely on physical work must be able to prove that there was continuous construction work through completion. Some tax equity investors and lenders were unwilling to take the risk that the continuous work requirement would be met. There is no need for projects that incur more than 5% of the total project cost by December 2011 to show that the work after that point is continuous.

There are two ways to start construction.

One is to commence physical work of a significant nature on the project by December 2011. The work can take one of two forms. It can be work at the site on foundations, concrete pads for wind turbines, concrete pedestals for solar arrays or permanent roads that will be used to ferry spare parts once the project is in operation. It is also physical work of a significant nature for a turbine or module manufacturer with whom a

developer has a binding contract to supply equipment to start physical assembly of the equipment at the factory.

The other way to start construction is to “incur” more than 5% of the total project cost by December 2011. It is not enough merely to make a payment in 2011. Costs are not “incurred” until equipment or services ordered under a binding contract are delivered, with one exception. A payment in 2011 counts as a 2011 cost if the equipment ordered is delivered within 3 1/2 months of the payment date.

A developer relying on the 5% test can add up the costs the developer incurs. It can also add costs that a contractor or equipment manufacturer with whom the developer has a binding contract incurs (without double counting).

There is a debate within Treasury about whether pulling components out of inventory counts toward costs incurred at the equipment manufacturer or contractor level. Until the issue is settled, developers would be wise to require equipment manufacturers only to use components that are manufactured after a binding purchase order is in place.

Developers who plan to rely on the 3 1/2-month rule to count the cost of equipment delivered in early 2012 must link payments in late 2011 to the specific equipment that will be delivered in early 2012. It is not enough to make a general down payment or general milestone payment under a contract.

The Treasury is unsure how the 3 1/2-month rule works for services. It has not decided whether services can be separately delivered from the equipment to which they relate in cases where the services are part of a larger equipment supply agreement. For example, design or engineering work may be embedded in the equipment and may not be delivered until the equipment is delivered.

Private Equity Funds

Developers who are owned partly by private equity funds cannot receive Treasury cash grants on their projects unless the funds hold their interests through “blocker corporations,” with one exception. The developer can benefit indirectly from a cash grant by selling the project to a tax equity investor and leasing it back. The tax equity investor can claim a full grant in that case, and the benefit is shared with the developer in the form of reduced rent for use of the project.

There had been talk at the staff level in the House tax committee about dropping the ban on cash grants for projects with private equity fund backing and moving instead to a “proportionate disallowance rule” / *continued page 3*

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where the grant would be lost to the extent of government and tax-exempt ownership of the project. Thus, for example, if state pension funds and university endowments own 10% of a private equity fund that owns 90% of a project indirectly through a developer, then only 9% of the grant would be lost.

Municipal utilities and electric cooperatives were also pressing to be able to receive Treasury cash grants on their projects.

The final bill was silent on these issues.

In addition to changing the deadline to start construction, the bill also changed a deadline to apply for Treasury cash grants. Grants are not usually applied for until after a project is completed. However, anyone expecting a grant had to apply to the Treasury by September 30, 2011 as a way of letting the government know how many more claims there might be on the program. That deadline has now been pushed back to September 30, 2012.

Depreciation Bonus

Companies that place new equipment in service after September 8, 2010 through December 2011 or 2012 will be able to deduct the cost immediately as a “depreciation bonus.”

The bonus replaces the regular depreciation that the company would otherwise have claimed.

However, only 85% of the cost can be deducted if a Treasury cash grant or investment credit is claimed.

Equipment that is normally depreciated over five or seven years must be in service by December 2011 to qualify for a 100% bonus. Examples are wind, solar, geothermal, landfill gas and parts of biomass and waste-to-energy projects.

Equipment at such projects still qualifies for a 50% bonus if placed in service in 2012. A 50% bonus means half the cost—or 42.5% of the cost for equipment on which a Treasury cash grant or investment credit is claimed—is deducted immediately. The remaining cost is deducted over the normal depreciation schedule.

Equipment that is normally depreciated over 10 or more years qualifies for a 100% bonus if placed in service by December 2012 and a 50% bonus if placed in service by December 2013. Examples are transmission lines and power plants that use fossil fuels. For this long-lived property, both the 100% bonus and the 50% bonus can only be claimed on costs incurred through 2012.

A company can opt out of the bonus, but it cannot choose

to take a 50% bonus instead of a 100% bonus.

Some careful tax lawyers have raised questions whether a Treasury cash grant can be claimed on projects on which a depreciation bonus is claimed. The Treasury cash grant program guidance says, “Costs that will be deducted for federal income tax purposes in the year in which they are paid or incurred are not includible in basis” for the cash grant. However, staff of the Joint Committee on Taxation said, after looking at the issue, that both the bonus and the grant are available on projects. Treasury confirmed this by email.

The bonus can only be claimed on equipment as opposed to buildings, land and intangible assets like power contracts and interconnection agreements. About 93% to 97% of spending at a conventional power plant is usually for equipment as opposed to a building and other improvements to real property.

The bonus can be claimed on projects in US possessions like Puerto Rico and the US Virgin Islands, provided they have US owners.

There is no bonus for investing in an existing facility, with four exceptions. “Existing” means it was already in operation when the taxpayer made the investment. First, new improvements to an existing plant qualify. Second, a tax equity investor can buy an existing project and lease it back to a developer up to three months after the developer put the project into service and claim a bonus. Third, the lessor in the sale leaseback has up to another three months after the sale-leaseback transaction closes to syndicate its position by offering interests in the lessor position to other investors. Fourth, a project developer can contribute an existing project to a partnership with a new investor at any time during the same tax year the project went into service, and the investor will get a share of the bonus. The IRS will require that the bonus be allocated between the project developer and the partnership based on the number of months that each owned the project during the year.

Project Too Stale?

Work on the project must not have started before 2008.

Most projects should qualify for a bonus as long as work “of a significant nature” did not start at the site before 2008. Site clearing, test drilling and excavation to change the contour of the land are not considered the start of work at the site. Work “of a significant nature” is considered to commence at the site once work starts on the foundation. IRS regulations say that driving pilings into the ground / *continued page 3*

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counts as work on the foundation. They also provide a “safe harbor” under which work is not considered to have reached the threshold “of a significant nature” until the taxpayer has incurred more than 10% of the expected total cost of the project. Spending on “land and preliminary activities such as planning or designing, securing financing, exploring, or researching” designs is ignored: it is not counted in either the numerator or the denominator. Thus, if a project is expected to cost \$300 million after backing out soft costs that are not allocated to the hard assets and after backing out the cost the land, design work and other preliminary activities, work is not considered to have reached the threshold “of a significant nature” until the taxpayer has incurred more than \$30 million.

The starting point for analyzing whether a project was too advanced before 2008 to qualify for a bonus is to decide whether the developer is “acquiring” the project or “self constructing” it.

“Acquired” property qualifies for a bonus only if there was no “binding” contract to acquire it before 2008.

“Self-constructed” property qualifies as long as work “of a significant nature” did not start at the site before 2008.

Most infrastructure projects are considered self constructed. The IRS regulations have an unusually broad definition of “self constructed.” Property is considered self constructed as long as the developer signed a contract with the manufacturer or contractor to have the property built for him before physical assembly of the property started. A contract is not “binding” if it limits the damages the owner must pay for canceling the contract to less than 5% of the total contract price. It is not a problem if the contract is silent about damages. There cannot be any conditions standing in the way of performance of the contract or the contract is not binding—unless the conditions are outside the control of the parties.

It is generally not possible to *create* a bonus where the project developer could not have claimed one—for example, because the project developer got started on the project too early to qualify—by selling the project to someone else during the window period and leasing it back. The IRS regulations have an “anti-churning rule.” However, the anti-churning rule is not well drafted.

Some developers may have taken delivery of turbines or other equipment that they no longer need and have parked in warehouses. If another developer were to buy one of these turbines today and use it, then he could claim a bonus on

the cost of it. That’s because the turbine was never put into service by anyone. Property is not considered used equipment until it has been in service.

On the other hand, if a developer bought a used turbine from another developer to incorporate into a new power plant, a bonus could not be claimed on the cost of it. A bonus cannot be claimed on used equipment.

This raises the question whether companies need meticulously to catalog whether used parts are used in the construction of their facilities. The answer is no. A company should determine whether parts that are large enough to qualify as separate “components” of a project are used property. The IRS does not define “component” in its regulations. Smaller parts are considered subsumed in a larger property, and unless more than 20% of its value is tied to the cost of used parts, the larger property is considered entirely new. Thus, for example, if a developer bought an older wind farm and rebuilt it using the latest generation of wind turbines, the entire project should qualify for a bonus—including the cost of acquiring the existing project—as long as the existing equipment does not account for more than 20% of the value of the wind farm after reconstruction.

Project Sales

Many power projects are expected to be put up for sale in 2011. Many of the projects sold will still be under development or construction. Anyone who buys a project before it is completed will qualify for a bonus, not only on the amount spent to complete the project but also on the amount paid to buy the work in progress to the extent the purchase price is allocated to equipment as opposed to other assets like a power contract or interconnection agreement. It does not matter that the original developer would not have qualified for a bonus had he kept the project.

Another common situation in infrastructure projects is where someone buys into a project—for example, as a partner—during the construction period. The analysis in such situations is more complicated than where a project that is still under construction is purchased outright. Someone buying into an existing partnership can claim a share of the bonus to which the partnership is entitled. However, he ordinarily cannot claim a bonus on any premium to buy into the project. (In other words, a bonus ordinarily cannot be claimed on a “section 754 stepup.”)

A developer who places a new project in service and sells the entire project later the same year / *continued page 5*

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to someone else cannot claim any bonus. The bonus is lost. (An exception is where the project is sold in a sale leaseback within three months after the project went into service.)

Some projects are owned by partnerships. A partnership “terminates” for tax purposes if at least a 50% interest in partnership capital and profits is sold. (The old partnership is considered to disappear and a new one to spring into being with the new partners.) If a project is put into service in a year and, later the same year, an interest in the partnership is sold causing the partnership to terminate, then the bonus is shared among the new partners—not the old ones.

Calculating the Bonus

The depreciation bonus is an acceleration of tax depreciation to which the owner of a project would have been entitled anyway.

The owner gets a much larger depreciation deduction the first year and, in the case of a 50% bonus rather than a 100% bonus, smaller ones later.

A faster writeoff can be a significant benefit. The benefit is greater the longer the normal depreciation period for an asset. A 50% depreciation bonus reduces the cost of assets that are depreciated over 20 years—for example, some transmission lines and coal- and combined-cycle gas-fired power plants—by 8.98%. It reduces the cost of gas pipelines and simple-cycle gas-fired power plants that are depreciated over 15 years by 7.54%. The cost of a generator that burns landfill gas is reduced by 3.61% (3.07% if a Treasury cash grant or investment tax credit is received on the project). Wind farms and biomass projects cost 2.61% less (2.22% for projects that receive Treasury cash grants or investment credits). These calculations only take into account *federal* tax savings from the depreciation bonus—not also the state tax savings—and they use a 10% discount rate.

The tax savings from a 100% bonus are twice these figures.

At least half of US states have “decoupled” from the depreciation bonus—they do not allow it to be claimed against state income taxes—and another group of states allows only a partial or delayed bonus.

A bonus cannot be claimed on property that is financed with tax-exempt bonds or that is leased to a government or tax-exempt entity or that is used predominantly outside the United States or US possessions.

Other Changes

Congress made a number of other changes in late December that will affect other energy projects.

The bill opened the door to place additional facilities for making “refined coal” in service and qualify for 10 years of tax credits on the output. “Refined coal” is coal that is less polluting than the raw coal used to produce it. Facilities put into service by December 2011 will now qualify for such tax credits.

It extended income and excise tax credits for ethanol, biodiesel, renewable diesel and alternative fuels at the existing rates, and the tariff on ethanol imports at the US border at the existing level, through December 2011.

Projects on Indian reservations will qualify for faster depreciation—for example, three-year instead of five-year depreciation for wind farms and solar projects—provided they are completed by December 2011.

The bill authorized another \$5.3 billion in additional “new markets tax credits” in each of 2010 and 2011 as an inducement to make loans or equity investments in projects in census tracts with lower-than-average family incomes or poverty rates of at least 20%.

It gave utilities more time through December 2011 to shed transmission assets to independent transmission companies or regional transmission organizations and spread the tax on any gain over eight years. ☺

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