SPECIAL UPDATE

CHADBOURNE & PARKE LLP

Treasury Rolls Out Cash Grant Program

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The US Treasury Department explained on July 9 how the new cash grant program for renewable energy projects will work, but said it will be August 1 before it will start accepting applications.

The explanation is in a paper posted on the Treasury website at www.treas.gov/recovery/1603.shtml. The Treasury also released a set of terms and conditions to which anyone receiving a grant will have to agree and the form that companies must fill in to apply for a grant.

The form is six pages, but it requires a number of items 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 has no discretion whether to pay grants; if a project qualifies, the owner is entitled to a grant. Congress provided an open-ended appropriation. Treasury officials said at a news conference on July 9 that they expect at least $3 billion to be paid under the program. They are expecting 5,000 applications. The money will be paid by wire transfer.

Grants will be 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 will also be paid on fuel cells, cogeneration facilities of up to 50 megawatts in size, gas micro-turbines and geothermal wells and pipes.

The grants are 30% of the project cost in most cases, but a cap of $3,000 per kilowatt of capacity applies to fuel cells. They are 10% on cogeneration facilities and gas micro-turbines.

They will only be paid on new facilities completed in 2009 or 2010 or that start construction in 2009 or 2010 and are completed by a deadline. The deadline is 2012 for wind farms, 2016 for solar, fuel cell, cogeneration facilities and gas micro-turbines, and 2013 for other renewable energy projects.

When Construction Starts

Developers of utility-scale solar projects were concerned that they would not be able to get their projects under construction by 2010 because the projects are often on federal land and require extensive environmental reviews before work can commence at the site. The Treasury had five precedents from which to choose for when construction starts.

It chose a definition at the early end of the spectrum.

Construction starts when the developer accrues at least 5% of the total project cost. However, it is not enough merely to have paid a turbine vendor or solar panel or boiler manufacturer installment payments amounting to at least 5% of the project cost; the factory must have started manufacturing the equipment and reached at least that stage percentage completion. The costs of land and preliminary activities that normally precede construction, like 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.

The 5% standard is a bright-line test.

A developer who cannot meet it may still be able to show that "physical work of a significant nature" began in 2010. However, the rules in this area are unclear. Anyone building a project himself will be considered to have started physical work of a significant nature once work begins at the site on excavation of the foundation, the setting of anchor bolts into the ground, or pouring concrete pads for the foundation. 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 all bets are off.

Some developers are less concerned whether they get work underway 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. Work on a geothermal project starts

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potentially when drilling commences on a dedicated well.

The Treasury said that it will treat each wind turbine, pad and tower as a separate facility, and treat the SCADA system, or the software and fiber optics 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 on a single site even though it is a string of wind turbines spread over several adjoining parcels leased from several 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 said there will be no recapture of cash grants except in three narrow circumstances.

One is where there is a change in use of a facility during the first five years after it is placed in service. For example, a biomass plant starts burning coal or, as one Treasury official said, a wind turbine is "turned into a Ferris wheel."

Recapture will occur if the project is permanently shut down during the first five years. 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.

Recapture will occur 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 US tax code, an electric cooperative or an 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 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, Indian tribe or electric coop. For example, 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 where 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, in which case the government would also have a claim against the general partner.

The cash grant vests ratably over five years. Any recapture would be only of the "unvested" grant. Thus, for example, a sale of the project to a tax-exempt entity in year 4 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 on renewable energy projects: tax credits and depreciation. Few US developers can use them. Most have bartered the tax benefits in the past to large institutional investors 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 economic stimulus bill last February gave developers the option to receive 30% of the project cost in cash from the US Treasury in exchange for forgoing tax credits on their projects.

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 in use currently: */ continued page 3*

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partnership flips, sale-leasebacks and inverted leases. Before the stimulus act, leasing was not an option for financing wind farms, biomass, geothermal and other projects on which production tax credits are claimed on the electricity output. The stimulus opened the door to all three structures for such projects by giving owners of the projects the option to claim an investment tax credit or receive a cash grant from the Treasury that is tied to the project cost in place of production tax credits. 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 flip partnership before the first turbine or solar array 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.

The Treasury said there is no recapture.

An investor may still want to invest early in deals where the parties plan to claim a "depreciation bonus." The bonus is a limited-time offer by the US 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 1.9¢ per 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 he is a partner before the assets on which the bonus will be claimed go into service. If he comes in later in the 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 where the investor comes into an existing partnership 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.

The cash grant will be paid to the entity that owns the project when it is put to "original use."

Most projects are owned by limited liability companies. Thus, the grant will be paid to the limited liability company. It does not matter how the LLC is treated for tax purposes (as a "disregarded entity," partnership or corporation).

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 lessor calculates the grant on his "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.

Solar companies 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, like a yo-yo put out on a string. The developer elects to leave the cash grant with the lessee.

The Treasury was still wrestling in late June with whether to allow a pass-through election. It decided to do so. 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. The lessee should make sure the lessor is barred from selling the project during the first */ continued page 4*

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five years to a tax-exempt entity. Any such sale would cause recapture of the cash grant paid to the lessee.

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 bars 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 was 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 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 income." Almost all do. The lone exception may be state pension funds.

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 clear 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 as a whole went into service. This has the effect of buying more time to put a blocker in place.

Applications

The Treasury does not want applications until projects have been placed in service for projects that go into service in 2009 and 2010. This will cut down on the time the government must spend on paperwork before files are ripe for review.

A developer may not have the final cost figures for some time after a project is completed. It would probably be best in such cases to apply with what he 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 suggested 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, 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 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 cash grant. Only part of the equipment at a project may qualify for the grant. An independent accountant will have to certify to 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 on their behalves and attests that certain conditions to funding have been */ continued page 5*

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satisfied. It 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 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 underway 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 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 <https://eupdate.dnb.com/requestoptions.asp>) 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 one to two days to register on the Central Contractor Registration (CCR) site (www.ccr.gov/startregistration.aspx). That process also is easy and requires filling out a form on line. Both registrations are free.

Other Issues

A company can assign the right to its grant to a lender or a tax equity investor directly. 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 power plant that uses renewable energy will be able to receive a cash grant on the improvements. However, the underlying power plant must have claimed production tax credits or claimed the investment tax credit in the case of a solar project or else the improvements must be so extensive as to turn the project into a new facility for tax purposes. The IRS uses an 80-20 test to determine whether improvements were extensive enough. They are if 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.

Renewable energy projects owned by regulated utilities will not qualify for cash grants unless the utility uses a normalization method of accounting.

The Treasury said 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.

Fuel handling and storage equipment at a plant that burns biomass or municipal solid waste qualifies for a grant if it is at the same site as the plant. However, pipelines, trucks, rail cars and barges that transport fuel to the site do not. If the plant burns a mix of fuels — some eligible and some ineligible — it can claim a cash grant only on the percentage of eligible fuel by Btu content in the year the project is placed in service. If the percentage falls any time during the next four years, then a share of the grant will be recaptured due to a change in use of the facility. This will complicate financings for biomass projects. No additional grant will be paid if the percentage increases.

The Treasury said that a cash grant can be claimed on all the intangible drilling costs at a geothermal project by electing under section 59(e) of the US tax code to amortize the costs over five years. Intangible drilling costs can normally be deducted as they are incurred. However, a taxpayer can choose one of two alternatives. One is to amortize the costs over five years. The other is to fold them into the basis in the wellfield equipment and mineral rights. The part allocated to the wellfield equipment is recovered through accelerated depreciation over five years and a cash grant can be claimed on it. The part allocated to the mineral rights is recovered, if at all, through depletion and no cash grant can be claimed on it. Geothermal companies may be more tempted after the guidance to make section 59(e) elections.

Cash grants can be claimed on energy storage devices that are part of a project. However, the device should store electricity from the project rather than store electricity pulled off the grid during off-peak hours to supplement troughs in output from the project.

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Grey Areas

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 US attorney. There are grey 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 email to 1603Questions@do.treas.gov. This may offer a means to get relatively quick answers even to tax-related questions. At the end of the day, the application is no different than the tax returns companies already file and on which they take positions while attesting to the accuracy of the information on the return. ◎

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