ARNOLD & PORTER LLP

ADVISORY

AUGUST 2009

FEDERAL CASH GRANT PROGRAM FOR RENEWABLE ENERGY PROPERTY NOW IN EFFECT

FINAL GUIDELINES RELEASED/APPLICATIONS BEING ACCEPTED

In our recent advisory on the energy provisions of the February 2009 Stimulus Law,[1] we reported that the Stimulus Law created a federal grant program for eligible renewable energy projects instead of the traditional production and investment tax credits.[2] The grant is equal to 30% of the tax basis of the system cost for projects placed in service in 2010 and 2011 or on which construction has commenced in 2009 or 2010 for equipment that will be placed in service after 2010. This is the first time that the federal government will give outright cash grants to subsidize renewable energy and there is no limit on the number of projects that are eligible for grants. The Stimulus Law designated the US Department of the Treasury (Treasury) to administer the program. While the Stimulus Law contained the statutory authorization for the program, Treasury needed to issue guidelines for applications before a request for a grant could be made.

In mid-July 2009, Treasury issued the guidelines for the program (the Program Guidance)[3]. Further, Treasury opened the system for applications on July 31, 2009. Applications can now be made through the website at http://www.treasury.gov/recovery/1603.shtml.

We are issuing this advisory to alert you that the program is "live" and so that project developers, financing parties, and owners of commercial real estate all realize the significance of the program. Simply put, if an owner of commercial real estate or a project developer installs renewable energy equipment in the next two and a half years or starts construction on a project, the federal government of the United States will pay 30% of the cost of the equipment and installation costs (once it is placed in service). This applies, for example, to onsite solar installations in commercial applications[4]. It should also be clear that this federal grant is on top of any state grants or incentives that may be available. In other words, if your business has been contemplating making use of renewable energy or you have been trying to develop a project, there has now been opened a unique two and a half year window to take advantage of unprecedented federal government support.

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

Financial Regulatory Reform

For more information and access to Arnold & Porter's latest resources on this topic including advisories, upcoming events, publications, and the Financial Regulatory Chart, which aggregates information on US government programs, please visit: http://www.arnoldporter.com/FinancialRegulatoryReform.

arnoldporter.com

TYPES OF RENEWABLE ENERGY ELIGIBLE FOR THE GRANT

By way of recall, the following is the list of equipment and projects that are eligible for the grants:

- Solar electric and thermal
- Geothermal, both electric generation and geoexchange heat pumps[5]
- Wind facilities (either large or small)
- Biomass, both closed-loop and open loop[6]
- Landfill gas facilities
- Hydroelectric facilities (limited to "incremental hydropower" (i.e., power generation from existing dams and other qualified facilities))
- Wave power (marine and hydrokinetic)
- Fuel cells (payment may not exceed US$1,500 for each 0.5 kilowatt of capacity)
- Microturbines (grant limited to 10% of system cost, maximum payment may not exceed an amount equal to US$200 for each kilowatt of capacity)
- Combined heat and power systems (grant limited to 10% of system cost)

It is also important to note that the grant is an outright grant. The Program Guidance makes clear that a grant for eligible energy property is not includable in the gross income of the recipient (except in one case relating to sale and leaseback transactions, discussed below). However, the recipient's tax basis in the property is reduced by 50% of the amount of the grant (as opposed to the usual rule of 100% basis reduction).

TYPES OF PROPERTY ELIGIBLE FOR GRANT

Within the broad categories of renewable energy equipment mentioned above, the Program Guidance provides some clarification as to the type of property to which the 30% grant applies, known as "specified energy property". Specified energy property is tangible property only—that is to say property for which depreciation (or amortization in lieu of depreciation) is allowable. This tangible property must both be used as an integral part of the activity performed by the qualified facility and be located at the site of the qualified facility.[7] A number of examples are given for different types of renewable projects. For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items, but does not include electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines. The Program Guidance includes other examples of what is and is not specified energy property for biomass, solid waste, and geothermal facilities.

The Program Guidance also goes into some detail as to what kind of documentation must be provided to demonstrate that the property is eligible, first and foremost being design plans and final engineering design documents, stamped by a licensed professional engineer.[8] More details on required documentation are given for specific types of eligible property, such as for biomass facilities, combined heat, and power systems and hydropower projects.

Further, the Program Guidance specifies that the 30% payment is calculated against the tax basis of the property placed in service, which is determined in accordance with the general rules for determining the basis of property for federal income tax purposes.[9] This means generally the cost of the property, unreduced by any other adjustment to basis, such as for depreciation, and includes all items properly included by the taxpayer in the depreciable basis of the property, such as installation costs and the costs for freight incurred in construction. The Program Guidance goes on to offer more specifics on calculating the basis of specified energy property.

MECHANICS OF GRANTS

As the provisions of Section 1603 of the Stimulus Law were relatively detailed as to eligibility for the grants and how they would be paid, the Program Guidance does not elaborate upon them in any great detail. It reiterates that payments will be made to qualified applicants in an amount equal to 30% of the tax basis of the property (or 10% in the case of combined heat and power and microturbines). For applications made on the basis of property being placed in service in 2010

and 2011, completed applications will be reviewed and payments made within 60 days after the later of the date of the complete application or the date the property is placed in service. This means that applications can be made after the property is placed in service, but they have to be made before October 1, 2011. As for applications based upon construction commencing in 2009 or 2010, applications have to be submitted after construction begins but before October 1, 2011. However, Treasury will not make the payment until the property is in fact placed in service. If the application is complete, Treasury will notify the applicant and it will then have to submit supplemental information within 90 days after the property is placed in service in order for Treasury to make a final determination. Payment is made within 60 days after the supplemental information is received. There are limits, however, to how long applicants have after 2011 to place the equipment in service if the application is being made on the basis of construction commencing. These are known as "Credit Termination Dates" and are listed in the Program Guidance. A chart of them appears as follows. The earliest is for large wind projects–January 1, 2013.

MEANING OF "PLACED IN SERVICE"

Since the payment of the grant is conditioned upon the qualified property being "placed in service," the Program Guidance elaborates on the meaning of the term. Stated simply, placed in service means that the property is ready and available for its specific use. It also specifies that a commissioning report must be provided either by the project engineer, the equipment vendor, or an independent third party that certifies that the equipment has been "installed, tested, and is ready and capable of being used for its intended purpose."[10] If the property being placed in service is being interconnected with a utility, as is typically the case for on-site power generation equipment, the interconnection agreement with the utility must also be provided. The Program Guidance seems to contemplate that the interconnection agreement need not be in effect in order for the grant to be obtained insofar as it says that "applicants must also submit any subsequent documentation to demonstrate that the interconnection agreement has been placed in effect".[11] If the meaning of this language is that submitting a form of interconnection agreement is sufficient to obtain the grant, this is of some significance, since arriving at final interconnection agreements with utilities can be a serious drag on the timing of on-site and other renewable generation projects.

Specified Energy Property	Credit Termination Date
Large Wind	Jan 1, 2013
Closed-Loop Biomass Facility	Jan 1, 2014
Open-Loop Biomass Facility	Jan 1, 2014
Geothermal under IRC sec. 45	Jan 1, 2014
Landfill Gas Facility	Jan 1, 2014
Trash Facility	Jan 1, 2014
Qualified Hydropower Facility	Jan 1, 2014
Marine & Hydrokinetic	Jan 1, 2014
Solar	Jan 1, 2017
Geothermal under IRC sec. 48	Jan 1, 2017
Fuel Cells	Jan 1, 2017
Microturbines	Jan 1, 2017
Combined Heat & Power	Jan 1, 2017
Small Wind	Jan 1, 2017
Geothermal Heat Pumps	Jan 1, 2017

CONSTRUCTION CONTRACT ISSUES

The Program Guidance goes into some detail about what it means to have commenced construction of qualified property, as this is much less straightforward then a determination of when equipment has been placed in service. Two situations are contemplated. One is where the owner of the property builds it itself and the other is when it enters into a binding contract with a third party to do it.

For owner-constructed property, construction begins when "physical work of a significant nature begins." The Program Guidance gives some examples of what does and does not constitute physical work. For a wind turbine, construction begins when significant site work commences, such as excavation for the foundation, the setting of anchor bolts into the ground, or the pouring of the concrete pads of the foundation. Preliminary work such as clearing a site, test drilling to determine soil condition or "excavation to change the contour of the land" does not constitute the beginning of

construction.[12] The Program Guidance also recognizes that much "construction" work actually takes place in projects when the equipment begins being assembled off-site. If a facility such as wind turbine and tower unit is to be assembled onsite from modular units manufactured offsite and delivered to the site, construction begins when physical work of a significant nature commences at the offsite location.

As for construction by contract, if the property is going to be produced for the applicant by another person, it must be under a "written binding contract" entered into before the manufacture, construction or production of the property.[13] Construction is then considered to begin when physical work of a significant nature begins under the contract. The Program Guidance gives some parameters as to what constitutes a binding contract. A contract is binding only if it is enforceable under state law against the applicant. Therefore, applicants for the grant will need to be advised by counsel familiar with construction contracting as to what is binding under the applicable state law of the construction contract.

The Program Guidance unfortunately contains some confusing indications about how limitations of liability and liquidated damages provisions in construction contracts affect their binding nature. According to the Program Guidance, a contract is binding only "if it does not limit damages to a specified amount (for example, by use of a liquidated damages provision."[14] This is an odd statement, since almost all construction contracts limit the contractor's overall liability and many use liquidated damages provisions for lateness and equipment under performance. Also, it is not uncommon for the contractor's potential exposure to liquidated damages to be limited as well. A typical construction contract might provide that the contractor's overall liability is limited to the contract price (or half of it) and that the contractor will not be liable for liquidated damages exceeding 10 or 20% of the contract price. There is nothing unenforceable about these provisions under state law.

However, the Program Guidance goes on to say that a contractual provision that limits damages to "an amount equal to ***at least 5%*** of the total contract price" [emphasis added] will not be treated as limiting damages to a specified amount. If this means that a contractual limitation of liability that is greater than 5% is acceptable for purposes of determining the binding nature of a construction contract that would be consistent with the practices of the construction industry as to limitations of liability and liquidated damages.

LEASED PROPERTY

The Program Guidance confirms that a grant can be made to a lessor and passed through to a lessee. This affirmation is important since the Stimulus Law was silent on the subject. Lease financing is a quite useful financing option for renewable energy projects. In order to pass through a grant payment to a lessee, the lessor must itself be eligible to receive a grant.

The Program Guidance is helpful in that it offers a fair amount of detail as to how the leasing aspect works.[15] An eligible lessor can make can make an election to pass-through the grant payment to a lessee if the property would be eligible for a grant payment if owned by a lessee. This election will treat the lessee as having acquired the property for an amount equal to the independently assessed fair market value of the property on the date the property is transferred to the lessee. The election will also generally follow the rules in the Internal Revenue Code and Treasury regulations governing elections to allow lessees to receive energy tax credits.[16]

The Lessor and lessee must agree that the lessor waives all right to a grant payment or a production or investment tax credit with respect to the eligible property before the lessee may apply for a grant payment for that property. Further, the lessee must agree to include "ratably" in its gross income over the five-year recapture period an amount equal to 50% of grant payment. This differs from the general rule, where the amount of the grant payment is not included in gross income of the party receiving the grant.

In order to make the election, both the lessor and the lessee must otherwise be persons eligible to receive grant payments (see below on ineligible recipients). For lessors, there are additional restrictions. Lessors that are mutual savings banks or "similar financial organizations," regulated investment companies or real estate investment trusts are

not eligible to receive grants for purposes of passing them through to lessees.

The Program Guidance also includes special rules for sale-leaseback transactions. In a typical sale and leaseback, a person who has developed or placed in service equipment loses title to the property by selling it to a lessor and leasing it back. The Program Guidance makes it clear that in the situation where qualified renewable energy property is sold and leased back, the lessee can still claim the grant payment if three conditions are satisfied:

- The lessee must be the person who originally placed the property in service
- The sale and leaseback must occur within three months after the property was originally placed in service; and
- The lessee and lessor must not make an election to preclude application of the sale leaseback rules.[17]

RECAPTURE RULES

The Program Guidance also includes a detailed discussion of when the government can claim recapture of the funds originally granted. The main disqualifying events are disposing of the property to a disqualified person or if the property ceases to qualify as specified energy property within five years after the property is placed in service. The Program Guidance elaborates upon the nature of each of these disqualifying events. As for disqualified persons, it refers to the list of entities who cannot claim the grant—federal, state, or local governments and any subdivision, agency, or instrumentality; a charitable corporation (501(c)(3)) that is exempt from tax; cooperative utilities or any partnership or other pass-through entity; and any partner or interest holder which is itself a disqualified person (see below for more detail on ineligible applicants). The Program Guidance does not include foreign persons as being disqualified under this list, but to the extent a foreign person is not allowed to receive a grant, a transfer to a foreign person would also be a disqualifying event.

The Program Guidance also makes an important point about structuring transactions in the event an otherwise disqualified person wishes to participate in a project that receives a grant. A disqualified person can be a shareholder in a taxable corporation that receives a grant. In this case, the renewable energy property would have to be owned by the taxable corporation. Many renewable energy project companies are organized as pass-through entities, however, or the property itself is held in a pass-through entity. In this case, a disqualified person can own its interest in a pass-through entity through a taxable corporation. According to the Program Guidance:

> A taxable corporation some or all of whose shareholders are disqualified persons is not a disqualified person and such a corporation's ownership of an interest in a partnership or other pass-thru entity will not cause the partnership or other entity to be treated as a disqualified person.[18]

As to the property's ceasing to qualify, the Program Guidance mentions a few specific instances. Permanent cessation of production will result in recapture. Temporary cessation of production will not result in recapture if the owner of the property intends to resume production at the time production ceases. If permanent cessation occurs as a result of a natural disaster, there will be no recapture unless the property is replaced with property that itself is eligible for a grant. Further examples of loss of eligibility for incremental hydropower production, biomass and combined heat and power are described.

If recapture must occur, it is done on a descending scale depending on the number of years the relevant property has been in service. If the disqualifying event occurs in the first year, 100% of the grant is recaptured; in the second year, 80%; in the third year, 60%; in the fourth year 40%; and in the fifth year, 20%. If the disqualifying event occurs after five years, no recapture is required.

If a grant recipient sells the qualified property to an entity other than a disqualified person, this does not result in recapture so long as the purchaser of the property agrees to be jointly and severally liable with the original applicant for any recapture (and the property continues to be qualified).

To be noted is that if the buyer of the property then transfers the property to a disqualified person, recapture is triggered and the original applicant remains liable for the recapture. Therefore, it would be advisable for original grant recipients who sell the property to receive adequate indemnities from the buyer to guard against this eventuality.

In the sale and leaseback situation, recapture could also arise if the lessor sells the property to a disqualified person. In that case, the lessee is liable to Treasury for the recapture amount even if the lessee maintains control over the property. Lessees will need to protect themselves against this eventuality in the sale and leaseback documentation.

The Program Guidance further clarifies that applicants are not required to post a bond as a condition of receiving a grant payment and that receipt of a payment does not create a lien on the property in favor of the government.

FINANCING

The Program Guidance contemplates that applicants can, in their request for payment, assign their grants to third parties. This would be for the purpose of facilitating financing of a project. In this case, the applicant has to comply with the notice of assignment requirements of the Federal Assignment of Claims Act.

INELIGIBLE PERSONS

The Program Guidance elaborates upon the provisions of Section 1603 with respect to persons that are not eligible to receive grants. They are:

- Federal, state, or local governments, or any political subdivision, agency, or instrumentality thereof;
- A 501(c)(3) corporation that is exempt from tax;
- Cooperative electric companies;
- A clean renewable energy bond lender; or
- Foreign persons (subject to some exceptions discussed below).

Since the grant is in lieu of production or investment tax credits, the basic idea is that persons who do not pay US tax should not be eligible for the grant. Further, the Program Guidance makes clear that applicants organized as partnerships or pass-through entities are not eligible if one of their direct or indirect partners (or other owners of equity or profits interests) is an ineligible person. As a result, ineligible persons cannot participate through pass-through entities. However, if an ineligible person forms a taxable corporation to participate in a pass-through applicant, this is permissible and the applicant remains eligible to receive a grant.[19]

Further, it should be pointed out that otherwise ineligible persons could form a taxable C corporation to be an eligible grant applicant. In the provisions on recapture, the Program Guidance provides that "[a] taxable corporation some or all of whose shareholders are disqualified persons is not a disqualified person …".[20] In these recapture provisions, the Program Guidance goes on to elaborate that a taxable C corporation's ownership of an interest in a partnership or other pass-through entity will not cause the partnership or other entity to be treated as a disqualified person, confirming the point above.

The private equity industry has criticized the exclusion of tax-exempt investors from eligibility for the grants.[21] Private equity funds are caught in this provision because many of them have investors or limited partners that are tax-exempt organizations. Even if a tax-exempt entity holds just a small interest in a project at upstream levels, the entire project is disqualified. The insertion of a "blocker" taxable corporation would allow participation of private equity funds with tax-exempt investors, but this adds a 35% tax on the project revenue at the blocker level.

FOREIGN PERSONS

As mentioned above, in a general sense foreign persons are considered to be ineligible to make direct applications for grants. However, the same rules that apply to other ineligible applicants would apply to foreign persons, namely that they could be shareholders of taxable C corporations who make the grant applications or shareholders of taxable C corporations that themselves are interest-holders in partnerships or pass-throughs. The disadvantages of foreign persons having to use blocker companies may be mitigated

somewhat by the provisions of tax treaties the US may have with the home country of a foreign investor; something that would have to be examined on a case-by-case basis.

There are also other exceptions regarding foreign persons. These are quite complicated, but the main one essentially has to do with foreign persons who have to pay US tax or are otherwise shareholders of a controlled foreign corporation under Subpart F. If more than 50% of the gross income of a foreign person is subject to US tax, it will be eligible to receive grants. The controlled foreign corporation is a foreign corporation that is owned more than 50% by US persons, typically offshore holding companies that American companies form to defer the repatriation and recognition of income in the United States.

Finally, property that is used more than 50% of the year outside the United States is not eligible for grants. Since most renewable energy equipment is rather stationary, it's hard to imagine how it could be used outside the United States more than half of the year. However, there is a long list of property under Section 168(g)(4) of the Code that will not be considered to be located predominately outside the United States, mostly transportation equipment. The main one of interest for purposes of the grant program is equipment that converts ocean thermal energy to usable energy.[22] This type of equipment would be eligible for the grant even if used more than half the year outside the United States.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Frederick R. Fucci
+1 212.715.1323
Fred.Fucci@aporter.com

Joseph G. Howe III
+1 202.942.5230
Joseph.Howe@aporter.com

(Endnotes)

1 The American Recovery and Reinvestment Act of 2009, P.L. 111-5

2 Section 1603 of the Stimulus Law. See "Tremendous Support for Renewable Energy and Efficiency in the Stimulus Law" (March 2009), available at: http://www.arnoldporter.com/resources/documents/CA_TremendousSupportForRenewableEnergy_031109.pdf.

3 "Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009," US Department of the Treasury, Office of the Fiscal Assistant Secretary, Program Guidance (July 2009).

4 Residential is not eligible.

5 Payment limited to 10% for heat pumps.

6 A "closed-loop" biomass facility is one that uses organic material from a plant cultivated exclusively for purposes of being used at a qualified facility to produce electricity. An "open-loop" biomass facility is one that uses waste materials such as livestock waste and other types of existing biomass, such as wood waste and agricultural sources.

7 Program Guidance, "Types of Property," p. 10.

8 Program Guidance, "Eligible Property," p. 8.

9 Program Guidance, "Eligible Basis," p. 15.

10 Program Guidance, "Placed in Service," p. 9.

11 Program Guidance, "Placed in Service," p. 10

12 Program Guidance, "Self Construction," p. 6

13 Program Guidance, "Construction by Contract, p. 6

14 Id.

15 Program Guidance, "Leased Property," p. 17

16 Code Section 48(d), as in effect immediately before enactment of P.L. 101-508 (1990). See also Code Section 50 (d)(5)

17 Code Section 48(b)(2), as in effect immediately before enactment of P.L. 101-508 (1990). See also Code Section 50(d)(4).

18 Program Guidance, "Recapture," p. 18.

19 "Having as a direct or indirect partner, shareholder or other similar interest holder a taxable C corporation any of whose shareholders are not eligible to receive Section 1603 payments does not affect the eligibility of the partnership or pass through entity." Program Guidance, "Applicant Eligibility," p. 4.

20 Program Guidance, "Recapture," p. 18.

21 Yuliya Chernova "US Renewable Energy Grant Rules Exclude Private Equity," *Wall Street Journal Online* (July 20, 2009) (http://online.wsj.com/article/BT-CO-20090720-709248.html)

22 Code Section 48(l)(3)(A)(ix) in effect on the day before the enactment of the Revenue Reconciliation Act of 1990.