Alternative & Renewable Energy Tax Newsalert

Treasury's 1603 Grant Program: New guidance clarifies application of the five-percent safe harbor

December 13, 2011

To be eligible for the Treasury 1603 grant program, companies must "begin construction" on their projects by December 31, 2011. Beginning of construction can be demonstrated by either incurring at least 5% of eligible project costs ("5% test") or beginning "significant physical work" in a plan of continuous construction. Many companies currently are working to satisfy the 5% test by year-end. However, some companies and advisors have wrestled with the effect of ownership changes on how the 5% test can be applied.

Earlier this week, Treasury updated its frequently asked questions document on beginning of construction to address issues surrounding this requirement. New Q&As 23 and 24 should provide companies with additional guidance regarding the 5% test.

Intragroup transfers and sale-leasebacks

New Q&A 23 provides guidance on the effect of changes of ownership of the energy property between the time the property is acquired for use in a project and the time the project is placed in service. It clarifies that the transferee of such property may be treated as having incurred any costs that were incurred by the transferor for purposes of applying the 5% test -- but only where the transferor acquired the property for use in that project and the transferor is related to the transferee within the meaning of section 197(f)(9)(C). Unrelated purchasers generally may not "step into the shoes" of the transferor for purposes of applying the 5% test, except in the case of a sale-leaseback transaction.

PwC observations

The new FAQs reflect Treasury officials' desire to facilitate intragroup and financing transactions while discouraging transactions that could be viewed as simply selling 1603 grant eligibility. As such, this guidance should be welcomed by companies who plan to incur safe harbor costs in 2011 and contribute renewable energy property to affiliated project companies at a later time. The guidance also confirms that sale-leaseback structures -- a popular form of financing for renewable or alternative energy projects -- may be structured without adversely affecting grant eligibility.

Effect of other ownership changes

New Q&A 24 provides guidance for projects in which ownership of the entity that meets the 5% test changes after December 31, 2011 and before the property is placed in service. Generally, grant eligibility will be maintained if the purchaser is an otherwise eligible Section 1603 applicant and the entity being sold had commenced development of a project. Here, Treasury will look for evidence of development

activity such as acquiring land, obtaining permits and licenses, entering into a power purchase agreement, entering into an interconnection agreement, and contracting with an EPC contractor. Purchasers of entities that have incurred no costs toward the 5% test other than equipment costs generally will not be permitted to rely on the 5% test.

PwC observations

Treasury officials have expressed concerns about literal readings of the grant guidance that may have allowed grant eligibility for shell companies that could then be resold to unrelated parties. The guidance here appears to address issues related to potential "trafficking" in renewable energy equipment without affecting project structures where other project activities have commenced. Applicants seeking to show that they have started work on a project may want to look to similar concepts under the section 45 production tax credit and should consider assembling both formal evidence of their intention to develop a project, such as the items listed in Q&A 24 and less formal evidence, such as marketing materials.

Other year-end issues

In a prior Newsalert, we commented on the application of the 3 1/2 month rule in Treas. Reg. §1.461-4(d)(6) to the 5% test. Companies seeking to meet the 5% test should consider how accounting method issues could affect the timing and computation of costs toward the 5% test.

For more information

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