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Section 1603 Renewable Energy Treasury Grant Program Update: IRS and OIG Audits and Sequestration Haircuts

Two recent developments may impact Section 1603 renewable energy Treasury grant program awards: (1) audits of grant recipients by the Internal Revenue Service (IRS) and Department of the Treasury's Office of Inspector General (OIG); and (2) a possible 7.6% sequestration haircut on grant awards made after the end of this year. Advanced preparation and strategic timing can reduce the risk of these developments negatively impacting grant awards.

Recent news reports that the IRS and OIG are auditing Section 1603 grant recipients should come as no surprise to the 7,420 recipients (so far) of Section 1603 grants. In light of the amount of funds distributed through that program, currently totaling more than \$14 billion, and the size of individual grants reaching \$543 million, the government's desire to confirm, through select audits, that such amounts were properly paid out has been expected. Moreover, in light of an expected flood of applications yet to come, these audits may inform Treasury policy for future applicants regarding certain aspects of the Section 1603 grant.

For the many future Section 1603 grant applicants that preliminarily qualified for the Section 1603 grant program by virtue of having placed projects in service before the end of 2011 and having filed preliminary applications before the end of September 2012, the news that sequestration may haircut the amount of a Section 1603 grant award clearly is unwelcome. These cuts may negatively impact the financial models used to determine the economic viability of renewable energy projects.

IRS and OIG Audits: Recent SEC Disclosure

As recent news reports have confirmed, a Securities and Exchange Commission (SEC) filing by solar panel installer SolarCity Corporation earlier this month disclosed that it and a number of other companies are being audited by the IRS and OIG in regard to Section 1603 grant awards. Those audits follow issuances by the IRS recently of "form" information and document requests (IDRs) and a number of audit reports issued by the OIG relating to Section 1603 grant awards.

IRS Audits

A Section 1603 grant is excludable from income for federal income tax purposes. Consequently, the IRS has concluded that it has jurisdiction to determine whether a Section 1603 grant was properly claimed and, thus, properly excluded from income. A number of Section 1603 grant recipients have begun receiving "form" IDRs (i.e., standard initial IDRs) from the IRS requesting information similar to that provided to Treasury in connection with the Section 1603 grant application.

The IRS audits disclosed in the recent SEC filing will include, not surprisingly, a review of the fair market value of solar power generation systems for which Section 1603 grant amounts were received. Should the IRS determine that the valuations used were incorrect, and consequently that the amount of a Section 1603 grant received was excessive, it could assess additional tax, interest and penalties. Any taxpayer that disagrees with any such assessment may challenge that assessment at IRS Appeals or, if necessary, in the courts.

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OIG Audits

The SEC filing also disclosed that OIG issued a subpoena with respect to Section 1603 grant awards, and that subpoenas have been issued to a number of other grant recipients. Those subpoenas require delivery of certain documents relating to participation in the 1603 grant program.

According to the SEC filing, OIG is working with the Civil Division of the U.S. Department of Justice (DOJ) to investigate the administration and implementation of the Section 1603 grant program, including possible misrepresentations concerning the fair market value of the solar power systems submitted for grant under that program. If at the conclusion of the investigation OIG concludes that misrepresentations were made, DOJ could bring a civil action to recover amounts it believes were improperly paid. If it were successful in asserting this action, a Section 1603 grant recipient may be required to pay damages and penalties for any funds received based on such misrepresentations.

Treasury has, to date, released audit reports of nine prior audits, the last report of which was dated in late August 2012. Reports regarding the audits disclosed in the SEC filing may not be released for more than a year, although reports for other ongoing audits may be released in the interim. Anyone involved with the grant program should stay apprised of the analysis and conclusions of those reports and any potential impact on previously filed or yet-to-be-filed grant applications.

Key Issues and Audit Procedures

Whether Section 1603 grant audits are conducted by the IRS or by the OIG, the primary issues will include:

- The proper cost basis of the renewable energy property upon which the grant amount was based;
- For projects placed in service after December 31, 2011, whether such projects satisfied the “beginning of construction” requirement for the Section 1603 grant (including for projects that received preliminary beginning of construction confirmations from Treasury); and
- Whether any recapture is required for post-grant award activity or inactivity.

An audit may include site visits by IRS and/or OIG personnel, interviews with company staff and the independent public accountants, written requests for information through IDRs or subpoenas, and a review of the original application and supporting documents. Once the IRS or the OIG makes an initial determination, they allow for a response by the company subject to audit, and IRS or OIG may amend its conclusions accordingly.

Sutherland Observation: Ultimately, any disagreement with the IRS or OIG may be resolved through administrative appeals and/or litigation. Section 1603 grant recipients, if contacted by the IRS or OIG, should quickly become familiar with the procedural aspects of such an audit, how to best manage an audit and the timeframes and procedures for challenging any determination that reduces or fully reverses a grant reward. Those applicants that received larger grants should consider preparing for an audit now, while the information that may be necessary to support a grant award is readily accessible and the people involved in the project are still available.

Sequestration: Potential Haircut of Section 1603 Grants

Should sequestration occur, recipients of Section 1603 grants may face a 7.6% haircut in a grant award. Automatic federal budget cuts, known as “sequestration,” will be triggered January 2, 2013, if Congress fails to enact a plan to reduce the deficit by \$1.2 trillion by the end of this year or otherwise fails to take action to delay sequestration. A recent report from the Office of Management and Budget confirmed that the Section 1603 grant program is subject to sequestration. As a result, any Section 1603 grant awards paid after the end of this year may be subject to the sequestration haircut unless Congress takes action that avoids that result.

The practical concern for many applicants is timing. To avoid a sequestration, a grant award must be received prior to the end of this year. Since the timing of receipt of a grant award is outside the control of an applicant, however, any grant application filed prior to year-end risks becoming subject to sequestration. That is the case because although Treasury statutorily is required to award Section 1603 grants within 60 days after an application is filed, that 60-day period restarts if Treasury requests further information. Notwithstanding that risk, any grant applicant seeking to receive a grant award prior to year-end should file an application as soon as possible and should follow Treasury guidance and utilize past experiences with Treasury grant application filings to ensure that the application is complete and includes all necessary information and documents. Of course, even with respect to grant applications filed before the end of this month, a substantial risk remains that grant awards for such applications will not be made prior to year-end and thus will be subject to a sequestration haircut.

Sutherland Observation: In strategically dealing with the sequestration haircut, Section 1603 grant applicants should consider whether a delay of the placed-in-service date (unless any such delay would be inconsistent with satisfying the beginning of construction requirement) or the filing of a final application (which is due within 90 days of the placed-in-service date) may be possible and appropriate. Although such a delay may give rise to operational issues and time value of money costs, it will also allow additional time for Congress to resolve the budgetary issues giving rise to the sequestration haircut, with the goal of ensuring that a full grant award will be received after the end of the sequestration period.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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