

On the Subject

Energy & Commodities Advisory

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Of particular importance, the Revised Guidance expands the application of a safe harbor used to determine when construction has begun.

Treasury Clarifies Guidance on the Meaning of When Construction Has Begun in Order to Qualify for Cash Grants

In July 2009, the U.S. Department of the Treasury issued guidance (2009 Guidance) and application materials for the cash grant program enacted under section 1603 of the American Recovery and Reinvestment Act of 2009 (Stimulus Act). The program provides a cash grant for placing in service certain renewable energy property. One of the requirements under the program is that the property is either (1) placed in service during 2009 or 2010, or (2) placed in service after 2010 (and before that property's credit termination date), but only if the construction of such property began during 2009 or 2010.

On March 15, 2010, Treasury revised its guidance on the cash grant program to clarify the meaning of when construction has begun (Revised Guidance). Of particular importance, the Revised Guidance expands the application of a safe harbor used to determine when construction has begun, perhaps though not entirely clear, allowing more projects to qualify for the safe harbor. Other than changes regarding the meaning of beginning of construction, the 2009 Guidance has not been revised.

Overview of Cash Grant Program

The cash grant provision was enacted as part of the Stimulus Act in response to the downturn in the economy and tax credit market. The cash grant program aims to stimulate new investment into renewable energy projects by offering a stimulus more immediate than tax credits—a direct cash payment. The program provides a cash grant for placing in service certain renewable energy property in lieu of the production tax credit or

the investment tax credit with respect to the property. Successful applicants will receive grants that equal 30 percent or 10 percent of the property's cost basis, depending on the type of property. Examples of property that may qualify for a cash grant include closed-loop and open-loop biomass property, fuel cell property, hydropower property, combined heat and power system property, small and large wind property, marine hydrokinetic property, solar property and microturbine property.

Beginning of Construction

In order for property placed in service after 2010 to qualify for the cash grant, construction of the property must begin during 2009 or 2010. Construction begins when physical work of a significant nature begins. Work performed by the applicant and by other persons under a written binding contract is taken into account in determining whether construction has begun. There are two ways to show that construction has begun: actual physical work of a significant nature, and satisfaction of the safe harbor by paying or incurring more than 5 percent of the total cost of the property.

Physical Work of a Significant Nature

Generally

Both on-site and off-site work may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. For example, in the case of a facility for the production of electricity from a wind turbine, on-site physical work of a significant nature begins with the beginning of excavating for the foundation, setting anchor bolts into the ground or pouring the concrete pads of the foundation. If the facility's wind turbines and tower units are to be assembled on site from components manufactured off site and delivered to the site, physical work of a significant nature begins when the manufacture of the components begins at the off-site location. If a manufacturer produces components for multiple facilities, reasonable methods must be used to associate individual components with particular facilities.

Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring, researching, clearing a site, test drilling of a geothermal deposit, test drilling to determine soil condition or excavating to change the contour of the land (as distinguished from excavating for footings and foundations).

Self-Construction

If an applicant manufactures, constructs or produces property for use by the applicant in the applicant's trade or business (or for the applicant's production of income), the work performed by the applicant is taken into account in determining when physical work of a significant nature begins.

Construction by Contract

For property that is manufactured, constructed or produced for the applicant by another person under a written "binding" contract that is entered into prior to the manufacture, construction or production of the property for use by the applicant in the applicant's trade or business (or for the applicant's production of income), the work performed under the contract is taken into account in determining when physical work of a significant nature begins. The 2009 Guidance provides rules to determine if a contract is binding, and the Revised Guidance does not change these rules, other than to clarify that minor modifications to the property's design specifications, such as cold weather packages for wind turbines, do not affect the binding nature of the contract.

Safe Harbor

Generally

Under the 2009 Guidance, an applicant may satisfy the safe harbor when the applicant incurs (in the case of an accrual basis applicant) or pays (in the case of a cash basis applicant) more than 5 percent of the total cost of the property. For purposes of determining whether an accrual basis applicant has "incurred" more than 5 percent of the total cost of the property, the economic performance standards of Internal Revenue Code section 461(h) apply, and, under those standards, economic performance generally occurs as services or property is provided (rather than when payment is made).

Under the Revised Guidance, an applicant may treat physical work of a significant nature as beginning when more than 5 percent of the total cost of the property has been paid or incurred, and, alternatively, may treat physical work of a significant nature as not having begun until more than 5 percent of the total cost of the property has been paid or incurred. The Revised Guidance no

longer provides that the economic performance standards of section 461(h) apply for purposes of determining whether an accrual basis applicant has incurred more than 5 percent of the total cost of the property. Thus, under the Revised Guidance, the safe harbor may be satisfied by paying or incurring 5 percent of the total costs, regardless of the applicant's accounting method.

In addition, under the 2009 Guidance, when property is manufactured, constructed or produced for the applicant by another person, the 5 percent threshold must be met by the applicant (not the other person). In contrast, the Revised Guidance provides two sets of rules on when costs of the property are treated as paid or incurred based on whether the property is constructed by the applicant or by another person, and, when the property is constructed by another person, certain costs of that person are now taken into account.

Self-Construction

In the case of property constructed by the applicant, costs of the property are treated as paid or incurred when paid or incurred by the applicant.

Construction by Contract

In the case of property manufactured, constructed or produced for the applicant by another person under a binding written contract that is entered into prior to the manufacture, construction or production of the property, the cost of the property under the contract is treated as paid or incurred when the property is provided to the applicant, and for periods before the property is provided to the applicant, when paid or incurred by such other person.

If the property includes both self-constructed components and components constructed under a contract, the costs relating to the self-constructed components and the costs relating to the components constructed under a contract are combined in determining if 5 percent of the total costs has been exceeded.

Significantly, this new test requires developers of renewable energy projects to work with manufacturers of components with respect to the grant application. In order to meet the safe harbor threshold, developers may need to request invoices and other documentation from manufacturers to substantiate the costs of the project.

Additional Clarifications in the Revised Guidance

All costs included in the eligible basis of the specified energy property and only such costs are taken into account in

determining if 5 percent of total costs has been exceeded. If the applicant is a lessee of property for which the lessor has elected to pass-through the credit to the lessee, this safe harbor must be met by the lessor (unless the applicant sold and leased back the property).

Reliance on Prior Guidance

An applicant may choose to determine when construction begins under the 2009 Guidance or the Revised Guidance. However, since the satisfaction of the construction rules in 2010 is critical for projects intending to obtain the grant, the revised and modified safe harbor and construction rules discussed above likely should be used. e

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