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GRANTS IN LIEU OF TAX CREDITS UNDER THE TAX RECOVERY ACT—*A SQUARE PEG IN A ROUND HOLE*

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Grants in Lieu of Tax Credits Under the Recovery Act—A Square Peg in a Round Hole

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Many issues are raised by the grant program and the guidance recently issued by Treasury, including the legal effect of the guidance, the resolution of disputes arising under the grant program, unanswered procedural questions under the program, and income tax issues relating to the treatment of grants. These areas of difficulty result from the imperfect fit of the grant program with the existing tax credit rules.

Before the American Recovery and Reinvestment Act of 2009 (P.L. 111-5, 2/17/09) (ARRA), various types of renewable energy property benefited for many years from tax subsidies in the form of two types of tax credits, *production* tax credits (PTCs) under Section 45 and *investment* tax credits (ITCs) under Section 48. The tax title of ARRA contained two unusual provisions:

- ARRA section 1102 added Section 48(a)(5) to the Code, allowing taxpayers to claim the Section 48 ITC with respect to investments in certain types of facilities that hitherto had been eligible only for the Section 45 PTC.
- ARRA section 1603 permitted persons placing certain qualified property in service to elect to receive cash grants from Treasury in lieu of claiming either the PTC or the ITC with respect to the property ("ARRA grants").

In July 2009, Treasury issued guidance setting forth (1) grant application procedures, (2) several substantive positions regarding the interpretation and implementation of ARRA section 1603, and (3) safe harbors relating to certain of those positions. The guidance represents a monumental effort on the part of Treasury to fit the square peg of the tax credit (particularly, the *very* square peg of the PTC) into the round hole of the grant program. Nevertheless, the guidance clearly represents a work in process. Many important questions about the operation of the grant program were left unanswered, and Treasury has faced a barrage of e-mailed questions from applicants and their advisors.[1] Treasury officials have stated that additional guidance is expected to be issued in the form of "frequently asked questions" and answers.[2]

It is likely that even additional guidance from Treasury will continue to leave many issues open. The governing statutory provisions are drafted in a manner that does not neatly merge the two kinds of credits and does not neatly merge the grant program with the credit eligibility rules on which it relies. The roughness of the statutory provisions has put Treasury in the difficult position of acting as a gatekeeper without clear guidance from Congress as to what is intended to move through the gate. As a result, Treasury may take positions that leave project owners with no choice but to initiate litigation.

PRE-ARRA CREDITS

The PTC and ITC provisions of the Code, independent of the changes wrought by ARRA, are summarized below.

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PTC—Qualified Energy Facilities

Under Section 45, a taxpayer that produces electricity from a "qualified energy resource" at a "qualified facility" and sells the electricity to an unrelated person[3] is entitled to a tax credit equal to a specified amount multiplied by the number of kilowatt hours (kWh) of electricity sold during the tax year.[4] The credit generally is available only with respect to electricity produced during the ten-year period beginning on the date the qualified facility was originally placed in service.[5]

The statute provides a detailed set of rules regarding the following matters: (1) What constitutes a "qualified energy resource" and (2) what constitutes a "qualified facility." Under Section 45(c)(1), qualified energy resources include only the following resources:

- Wind.
- Closed-loop biomass.
- Open-loop biomass.
- Geothermal energy.
- Solar energy.
- Small irrigation power.
- Municipal solid waste.
- Qualified hydropower production.
- Marine and hydrokinetic renewable energy.

Section 45(c) provides detailed rules elaborating on the meaning of each of the foregoing.

The governing statutory provisions are drafted in a manner that does not neatly merge the two kinds of credits.

The rules for identifying "qualified facilities" generally do not describe facilities in terms of their design or function. Rather, those rules generally (1) set forth periods during which the facility, or modifications/expansions of a facility, must be placed in service and (2) ensure that the PTC for production by a facility will not duplicate other tax credits available for the same facility.[6]

The PTC is expressly designed to subsidize the production of electricity using the specified qualified energy resources. Scant attention is paid to specifying the nature of the property constituting the qualifying facility from which it is produced, other than through placed-in-service requirements. Indeed, "facility" is undefined, and there are no limitations on what property is included in a facility.

Consider, for example, the production of electricity from municipal solid waste at a trash facility. Section 45(c)(6) defines "municipal solid waste" as having "the meaning given the term 'solid waste' under section 2(27) of the Solid Waste Disposal Act (42 U.S.C. 6903)." Section 45(d)(7) generally defines "trash facilities" as follows: "In the case of a facility ... which uses municipal solid waste to produce electricity, the term 'qualified facility' means any facility owned by the taxpayer which is originally placed in service after the date of the enactment of this paragraph and before January 1, 2014." Nothing in this definition restricts the scope of a qualifying trash facility. As long as a facility uses municipal solid waste (as defined) to produce electricity, and it is placed in service after the date of enactment of Section 45(d)(7) and before 2014, it is a qualifying trash facility.

To put this in perspective for our purposes, consider for comparison the ITC provisions for energy property that were adopted in the Energy Tax Act of 1980. Section 301(b) of the Energy Tax Act added (former) Section 48(l) as part of the ITC provisions then in effect.[7] Former Section 48(l)(1)(A) provided that "energy property" was treated as "section 38 property," i.e., as property potentially eligible for the ITC. One of the categories of "energy property" was "recycling equipment."[8] Eligible recycling equipment included "any equipment which is used in the conversion of solid waste into a fuel or into useful energy such as steam, electricity, or hot water."[9]

Another category of energy property under former Section 48(l) was "alternative energy property." Under former Section 48(l)(3)(A), alternative energy property included the following property:

"(i) a boiler the primary fuel for which will be an alternate substance,

"(ii) a burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if

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1 Treasury maintains a website for the grant program (at www.treas.gov/recovery/1603.shtml) that includes the following statement: "Please e-mail any questions you may have to 1603Questions@do.treas.gov. Please note that the purpose of the 1603 mailbox is to answer questions regarding how to apply for the 1603 program. This includes: how to submit an application, assign a payment, and prepare the independent accountant's report. We also answer general questions regarding applicant and property eligibility. We cannot, however, answer questions that are more appropriately answered by tax accountants, lawyers and the Internal Revenue Service. This includes questions regarding what can and cannot be included in cost basis and whether or not certain business structures meet eligibility requirements. Also, we cannot confirm eligibility for specific projects."

2 See, e.g., 2009 TNT 186-12 (9/29/09), reporting remarks of Charles Ramsey, Chief, Branch 6, IRS Office of Associate Chief Counsel (Passthroughs & Special Industries).

3 "Related person" is defined in Section 45 (e)(4).

4 Under Section 45(a)(1), the base amount of the credit is 1.5 cents per kWh. Section 45 (b)(2) provides that this amount is increased by an inflation factor. The amount of the credit for sales of electricity in 2009 is 2.1 cents per kWh; see Notice 2009-40, 2009-19 IRB 931. Under Section 45(b)(4)(A), the amount of the credit is reduced by one half for electricity produced by the following categories of qualified facilities: open-loop biomass, small irrigation power facilities, landfill gas facilities, trash facilities, qualified hydropower facilities, and marine and hydrokinetic renewable energy facilities.

5 Section 45(a)(2)(A)(ii). Under Section 45(b)(4)(B), the ten-year period during which the production tax credit is available is reduced to five years for the following categories of qualified facilities: open-loop biomass, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash facilities.

6 See, e.g., Section 45(d)(1), relating to wind facilities (excluding any facility with respect to which any qualified small wind energy property expenditure (as defined in subsection (d)(4) of Section 25D) is taken into account in determining the credit under such section).

7 The ITC provisions in former Section 48(l) were generally repealed by section 11813(a) of OBRA '90.

8 Former Section 48(l)(2)(A)(iv).

9 Former Section 48(l)(6)(D).

the primary fuel for such burner will be an alternate substance,

"(iii) equipment for converting an alternate substance into a synthetic liquid, gaseous, or solid fuel, ...

"(vii) equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation (including, but not limited to, washing, crushing, drying, and weighing) at the point of use of an alternate substance for use in equipment described in clause (i), (ii), (iii), (iv), (v), or (vi)...."

With regard to equipment described in the immediately preceding paragraph, former Section 48(l)(3)(A) provided the following clarification: "The equipment described in clause (vii) includes equipment used for the storage of fuel derived from garbage at the site at which such fuel was produced from garbage."

For purposes of the preceding provisions, "alternate substance" was broadly defined to include "any substance other than—(i) oil and natural gas, and (ii) any product of oil and natural gas."[10]

The rules for identifying 'qualified facilities' generally do not describe facilities in terms of their design or function.

Under these provisions, a facility of the type that is referred to in current Section 45(d)(7) as a "trash facility" may have qualified under former Section 48(l) as either a "recycling facility" or an "alternative energy facility." As the tax subsidy for such a facility was an ITC, it was critical for the taxpayer and the IRS to be able to identify specific property that was considered to be part of the facility and the cost of which was eligible to be included in the base on which the credit was computed.

Reg. 1.48-9 provided detailed guidance under former Section 48(l), addressing, among other things, issues having to do with the permissible scope of a chain of processes relating to the functions of particular types of energy property. Some illustrative excerpts follow.

The following relate to "alternative energy property":

- "A burner includes equipment (such as conveyors, flame control devices, and safety monitoring devices) located at the site of the burner and necessary to bring the alternate substance to the burner."[11]
- "Alternative energy property includes equipment (handling and preparation equipment) used for unloading, transfer, storage, reclaiming from storage, or preparation of an alternate substance for use in eligible alternative energy property (as defined in paragraph (c)(9)(ii) of this section). Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock."[12]
- "Handling and preparation equipment does not include equipment, such as coal slurry pipelines and railroad cars, that transports a fuel or a feedstock to the site of its use."[13]

The following relate to "recycling equipment":

- "*Conversion equipment.* Conversion equipment includes equipment that converts solid waste into a fuel or other usable energy, but not beyond the point at which a fuel, steam, electricity, hot water, or other useful form of energy has been created. Thus, combustors, boilers, and similar equipment may be eligible if used for a conversion process, but steam and heat distribution systems between the combustor or boiler and the point of use are not eligible."[14]
- "*On-site related equipment.* Recycling equipment also includes on-site loading and transportation equipment, such as conveyors, integrally related to other recycling equipment. This equipment may include equipment to load solid waste into a sorting or preparation machine and also a conveyor belt system that transports solid waste from preparation equipment to other equipment in the recycling process."[15]

The foregoing embody the Service's interpretation and implementation of now-repealed provisions of the Code that allowed an ITC for specified types of property that were similar to facilities (and components of facilities) producing electricity that is now eligible for the PTC. The Regulations under former Section 48(l) do not, however, apply to existing provisions of the Code.

ITC for Energy Property

Section 48, in conjunction with Sections 38 and 46,[16] allows an "energy credit" equal to "the energy percentage of the basis of each energy property placed in service during such taxable year." The "energy percentage" is either 30% or 10%, depending on the type of energy property involved.

Section 48(a)(3) defines "energy property" to include any of the following seven specified types of property, as long as they meet three requirements:

- Equipment that uses solar energy to generate electricity, to heat or cool a structure, to provide hot water for use in a structure, or to provide process heat.
- Equipment that uses solar energy to illuminate the inside of a structure using fiber optics.
- Equipment used to produce, distribute, or use energy derived from a geothermal deposit (not including electrical transmission equipment).
- Qualified fuel cell property or qualified microturbine property.

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10 Former Section 48(l)(3)(B).

11 Reg. 1.48-9(c)(4)(iii).

12 Reg. 1.48-9(c)(9)(i).

13 Reg. 1.48-9(c)(9)(iv).

14 Reg. 1.48-9(g)(3).

15 Reg. 1.48-9(g)(4).

16 Section 38(a) allows a credit equal to the current year "business credit," as well as business carryforwards and carrybacks. Section 38(b)(1) provides that the "business credit" includes "the investment credit determined under section 46." Section 46(2) provides that the "investment credit" includes the "energy credit." Section 48 defines the "energy credit."

- Combined heat and power system property.
- Qualified small wind energy property.
- Equipment that uses the ground or ground water to heat or cool a structure.

The provisions describing some, but not all, of these categories of energy property contain placed-in-service limitations. For example, equipment that uses solar energy to illuminate the inside of a structure using fiber optics is treated as energy property only if it is placed in service in a tax year ending before 2017.[17] Other eligible equipment using solar energy may be treated as energy property regardless of when it is placed in service, but the applicable "energy percentage" for such property is reduced from 30% to 10% if the property is not placed in service in a tax year ending before 2017.[18]

The three requirements that apply to all categories of energy property (and are part of the definition of "energy property") are:

1. Either the construction, reconstruction, or erection of the property must be completed by the taxpayer or the original use must commence with the taxpayer.[19]

2. The cost of the property must be depreciable or amortizable.[20]

3. The property must meet any performance and quality standards that may be prescribed.[21]

The ITC is limited in several ways by Section 50, which contains rules that fall into three categories:

- Eligibility for the credit.
- Recapture of the credit.
- Collateral effects on taxable income.

These Section 50 rules, which could have a significant impact on the ITC, are summarized below.

Eligibility rules. In general, the ITC is not allowed with respect to property that is used predominantly outside the U.S.[22] Moreover, the ITC generally is not allowed with respect to property used by an organization that is exempt from tax, unless the property is used predominantly in an unrelated trade or business the income of which is subject to tax under Section 511.[23]

Also, the ITC generally is not allowed with respect to property used by a domestic governmental entity[24] or by a foreign person or entity.[25] For purposes of determining whether property is "used by" an exempt or governmental entity, the "tax-exempt use property" rules in Section 168(h) are taken into account.[26] Under those rules, tangible property other than nonresidential property generally is treated as "tax-exempt use property" if it is leased to a tax-exempt entity (which includes most types of governmental entities).[27]

Recapture rules. If property with respect to which an ITC has been allowed is disposed of, or ceases to be eligible for the credit, before the end of five full years following the date on which the property was placed in service, a portion of the credit must be recaptured for the tax year in which the disposition or disqualification occurs.

The amount recaptured is the credit multiplied by a percentage equal to 20% times the number of full or partial years remaining in the five-year recapture period.[28] If energy property is placed in service by a partnership, and an ITC is claimed by a partner with respect to the property, a reduction of the partner's share of partnership profits within the recapture period for the property can cause a recapture of all or a portion of the credit claimed by the partner.[29]

Collateral effects on taxable income. If the ITC is claimed with respect to a property, the basis of the property must be reduced by 50% of the amount of the credit.[30] As a result, depreciation deductions over the life of the property will be lower than would have occurred in the absence of the credit, and gain (or loss) recognized on a sale or exchange of the property will be greater (or less).[31]

NEW SECTION 48(a)(5)

Under Section 48(a)(5), effective for facilities placed in service after 2008, a taxpayer may make an irrevocable election (the "ITC election") with respect to any of certain categories of facility described in Section 45.[32] If the taxpayer makes an ITC election with respect to a facility, the facility will be treated as a "qualified investment credit facility," and "any qualified property which is part of [the] facility" will be "treated as energy property" for purposes of Section 48, with an energy percentage of 30%.

The following categories of facilities described in Section 45(d) are eligible for the ITC election, as long as they are "qualified facilities" within the meaning of Section 45 and, under Sections 48(a)(5)(C)(i) and (ii), are placed in service in calendar years 2009 through 2013 (2009 through 2012 in the case of wind facilities):

- Wind facilities.
- Closed-loop and open-loop biomass facilities.
- Geothermal and solar energy facilities.
- Landfill gas facilities.
- Trash facilities.
- Qualified hydropower facilities.
- Marine and hydrokinetic renewable energy facilities.

Property that is "part of" a qualified investment credit facility" is "qualified property" as long as the cost of the property is subject to de-

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17 Section 48(a)(3)(A)(ii).
18 Section 48(a)(2)(A)(i)(II).
19 Section 48(a)(3)(B).
20 Section 48(a)(3)(C).
21 Section 48(a)(3)(D).
22 Section 50(b)(1).
23 Section 50(b)(3).
24 Section 50(b)(4)(A)(i).
25 Section 50(b)(4)(A)(ii).
26 Section 50(b)(4)(E).
27 Section 168(h)(1)(A).
28 Section 50(a)(1).
29 Regs. 1.47-6(a)(2) and 1.704-1(b)(4)(vii).
30 Sections 50(c)(1) and 50(c)(3)(A). If there is a recapture event with respect to the property, the basis adjustment is correspondingly reversed. Sections 50(c)(2) and 50(c)(3)(B).
31 For purposes of computing E&P of a corporation, however, depreciation is determined without regard to the Section 50(c) basis adjustment; see Section 312(k)(5).
32 Section 48(a)(5)(C).

preciation or amortization[33] and the property is either (1) "tangible personal property"[34] or (2) "other tangible property (not including a building or its structural components), but only if such property is used as an integral part of the qualified investment credit facility."[35]

As noted above, property that satisfies the foregoing requirements is "treated as energy property" for purposes of Section 48. As a technical matter, this means that the requirement in Section 48(a)(3)(B) that either (1) the construction, reconstruction, or erection of the property must be completed by the taxpayer or (2) the original use of the property must commence with the taxpayer, which is part of the generally applicable definition of "energy property," does not apply to property that is treated as energy property by reason of an ITC election.

THE ARRA SECTION 1603 STATUTORY SCHEME

The grant program is not part of the income tax system, and Treasury's role in the program is wholly unlike the role of the IRS in implementing a subsidy in the form of a tax credit. An analysis of the legal underpinnings of the grant program must begin with a clear look at the statute.

The Statutory Mandate

Our focus in this section is on the absence from the statute of any express grant of discretionary authority to Treasury. Following is a brief summary of section 1603:

- The first sentence of subsection (a) provides: "Upon application, the Secretary of the Treasury shall, subject to the requirements of this section, provide a grant to each person who places in service specified energy property to reimburse such person for a portion of the expense of such property as provided in subsection (b)."[36]
- The second sentence of subsection (a) limits ARRA grants to property that is placed in service within specified times.
- Subsection (b) provides a formula for determining the amount of the grant.
- Subsection (c) provides that grants shall be made as of a specified time relative to (1) the application date and (2) the placed-in-service date for the subject property.
- Subsection (d) defines "specified energy property" by cross-reference to Sections 45 and 48 of the Code.
- Subsection (e) defines a term used in the placed-in-service rule in subsection (a).
- Subsection (f) provides: "In making grants under this section, the Secretary of the Treasury shall apply rules similar to the rules of section 50 of the Internal Revenue Code of 1986. In applying such rules, if the property is disposed of, or otherwise ceases to be specified energy property, the Secretary of the Treasury shall provide for the recapture of the appropriate percentage of the grant amount in such manner as the Secretary of the Treasury determines appropriate."
- Subsection (g) provides that "[t]he Secretary of the Treasury shall not make any grant" to certain specified types of persons.
- Subsection (h) refers to Sections 45 and 48 for the meanings of "[t]erms used in this section which are also used" in those Code sections.
- Subsection (i) appropriates all necessary funds for the making of grants.
- Subsection (j) provides that grants may be made only in response to applications received before 10/1/11.

In all of these provisions, the only suggestion that Treasury has any discretionary authority is in subsection (f), which directs Treasury to "apply rules similar to the rules of" Section 50.

The legislative history of ARRA section 1603 similarly does not indicate that Treasury is given discretion in administering the grant program. Oddly, the Conference Report states that the House bill "*authorizes* the Secretary of Energy to provide a grant to each person who places [specified energy property] in service during 2009 or 2010 . . . ."[37] The House bill actually provided, "the Secretary of Energy *shall*" provide a grant to each such person. Similarly, the Conference Report states: "The grant *may* be paid to whichever party would have been entitled to a credit under section 48 or section 45, as the case may be." Notwithstanding the use of "authorizes" and "may" in the Conference Report, there is no indication in the report that the Conference Committee intended any inference that "shall," as used in ARRA section 1603(a), has anything but its ordinary meaning.

'Facility' is undefined for purposes of the PTC, and there are no limitations on what property is included in a facility.

Thus, subject to the latitude that any federal agency has in administering a program under its jurisdiction, it does not appear that Treasury has any discretion to decline to issue

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33 Section 48(a)(5)(D)(ii).

34 Section 48(a)(5)(D)(i)(I).

35 Section 48(a)(5)(D)(i)(II). Notwithstanding that the "integral part" requirement relates only to "other tangible property," and not to "tangible personal property," Notice 2009-52, 2009-25 IRB 1094, section 2.01(2)(ii), states that a taxpayer making an election under Section 48(a)(5)(C) must attach a statement to the taxpayer's Form 3468 that includes "[a] detailed technical description of the energy property placed in service during the taxable year as an integral part of the facility, *including a statement that the property is an integral part of such facility.*" (Emphasis added.) The required statement is not limited to tangible personal property.

36 The phrase "to reimburse such person for a portion of the expense of such property" does not appear to have any meaning or effect. Since subsection (b) simply describes the amount of the grant, there does not seem to be any reasonable way of reading the phrase "as provided in subsection (b)" as modifying anything in the sentence other than "provide a grant."

37 H. Rep't No. 111-16, 111th Cong., 1st Sess. 620 (2009).

a grant to which an applicant is entitled under the terms of the statute.

Eligible Property

ARRA section 1603(d) defines "specified energy property" using one general cross-reference relating to facilities described in Section 45 and seven specific cross-references to property described in Section 48. It is important to track the cross-references precisely.

The general cross-reference in section 1603(d)(1) relating to facilities described in Section 45 reads as follows: "Any qualified property (as defined in section 48(a)(5)(D) of the Internal Revenue Code of 1986) which is part of a qualified facility (within the meaning of section 45 of such Code) described in paragraph (1), (2), (3), (4), (6), (7), (9), or (11) of section 45(d) of such Code."

As discussed above, Section 48 (a)(5)(D) provides that "qualified property" is any property that has the following characteristics:

- It is either (1) tangible personal property or (2) other tangible property (not including a building or its structural components), but only if such property is used as an integral part of "the qualified investment credit facility."[38]
- It is depreciable or amortizable.

"Qualified facility" is defined separately in Section 45 for each category of facility to which that provision applies. In each case, the applicable subdivision of Section 45 defines "qualified facility" by reference to (1) the fuel source or other energy input used by a facility to produce electricity and (2) applicable placed-in-service requirements. Not surprisingly, since the credit allowed under Section 45 is based on production of electricity, and not on the amount of an investment in property, there are no rules in Section 45 itself that describe or limit what is "eligible" property. Thus, property connected with one of the specified facilities to which Section 45 applies is eligible for an ARRA grant as long as it satisfies the requirements described in the bulleted paragraphs above and the applicable placed-in-service rules in ARRA sections 1603(c) and (e).

The specific cross-references in section 1603(d) to other property described in Section 48 are as follows:

"(2) QUALIFIED FUEL CELL PROPERTY.—Any qualified fuel cell property (as defined in section 48(c)(1) of such Code).

"(3) SOLAR PROPERTY.—Any property described in clause (i) or (ii) of section 48(a)(3)(A) of such Code.

"(4) QUALIFIED SMALL WIND ENERGY PROPERTY.—Any qualified small wind energy property (as defined in section 48(c)(4) of such Code).

"(5) GEOTHERMAL PROPERTY.—Any property described in clause (iii) of section 48(a)(3)(A) of such Code.

"(6) QUALIFIED MICROTURBINE PROPERTY.—Any qualified microturbine property (as defined in section 48(c)(2) of such Code).

"(7) COMBINED HEAT AND POWER SYSTEM PROPERTY.—Any combined heat and power system property (as defined in section 48(c)(3) of such Code).

"(8) GEOTHERMAL HEAT PUMP PROPERTY.—Any property described in clause (vii) of section 48(a)(3)(A) of such Code."

These cross-references bypass certain limiting language in Section 48. As noted above, Section 48 allows an ITC for property described in the foregoing subdivisions only if all of the following requirements are satisfied:

- Either (1) the construction, reconstruction, or erection of the property is completed by the taxpayer,[39] or (2) the property is acquired by the taxpayer and the original use of the property commences with the taxpayer.[40]
- The property is depreciable or amortizable.[41]
- The property meets any performance and quality standards that have been prescribed and are in effect at the time the property is acquired.[42]

The flush language at the end of ARRA section 1603(d) substitutes for the second of these requirements, but nothing in section 1603 incorporates, or substitutes for, the first or the third requirement.

It does not appear that Treasury has any discretion to decline to issue a grant to which an applicant is entitled under the terms of the statute.

What does all this mean? Reading the provisions literally, it means that, in some circumstances, the owner of property may be eligible for a grant even though the property is not eligible for an ITC. For example, the "original use" requirement under Section 48(a)(3)(B)(ii) does not literally apply to *any* category of "specified energy property" described in ARRA section 1603(d).

Of course, the foregoing statutory provisions must be read in light of the legislative history. The following passage in the Conference Report has some bearing: "It is intended that the grant provision mimic the operation of the credit under section 48. For example, the amount of the grant is not includable in gross income."[43]

Arguably, the first sentence in this passage could be read to demonstrate that Congress intended that grants would be available only with respect to property that would be eligible for the credit under Section 48. In context, however, the sentence appears to be addressing the collateral consequences of grants, rather than eligibility for grants. Moreover, the statutory language is unambiguous, and it is difficult to see how a court

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[38] "Qualified investment credit facility" is used in Section 48(a)(5)(C) and refers to the same categories of facilities that are referred to by "qualified facility" in section 1603(d)(1), except that the definition of "qualified investment credit facility" in Section 48(a)(5)(C) has a placed-in-service-date component.

[39] Section 48(a)(3)(B)(i).

[40] Section 48(a)(3)(B)(ii).

[41] Section 48(a)(3)(C).

[42] Section 48(a)(3)(D).

[43] H. Rep't No. 111-16, *supra* note 37, page 621.

could use the Conference Report language as a basis for disregarding the plain meaning of the statute.

If Congress did not intend to create these differences between the energy ITC and the grant program, a technical correction to the statute may be appropriate.

Eligible Persons

As noted above, section 1603(g) provides that "[t]he Secretary of the Treasury shall not make any grant" to persons in certain categories. Those categories include exempt entities, several types of governmental entities, and "any partnership or other pass-thru entity any partner (or other holder of an equity or profits interest) of which" is one of the identified exempt or governmental persons.

What is notable about this provision is that it does not state that the specified categories of exempt and governmental persons are ineligible to receive grants. Rather, it directs that Treasury "shall not make any grant" to such a person. This raises the following question: What happens if Treasury makes a grant to a person and later determines that the recipient is in one of the listed exempt or governmental categories? The answer to this question is not clear.

Incorporation of Code Terminology

As noted above, ARRA section 1603(h) provides that "[t]erms used in this section which are also used in section 45 or 48 of the Internal Revenue Code of 1986 shall have the same meaning for purposes of this section as when used in such section 45 or 48." There are a number of terms used in section 1603 that are clearly "used in" Section 45 or 48 within the intendment of this provision, including:

- "Placed in service" is used in section 1603(a)(1) and is used in Section 48(a)(1).
- "Basis" is used in section 1603(b)(1) and is used in Section 48(a)(1).
- "Depreciation" and "amortization" are used in section 1603(d) and are used in Section 48(a)(3)(C).

The context in which the foregoing terms are used in ARRA section 1603 makes it clear that Congress intended the terms to have the same meaning as in Section 48.

The statute is unambiguous, and it is difficult to see how a court could use the Conference Report as a basis for disregarding the plain meaning of the statute.

There is at least one other term used both in section 1603 and in Section 45 or 48 where the intention to use a parallel definition is less clear: "person" is used in ARRA section 1603(a), and it is also used several times in Section 45.[44] "Person" is not defined in Section 45, however, and it is not clear exactly what meaning the term is intended to have.

Section 7701(a) states: "When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—(1) Person. The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." Reg. 301.7701-6(a) provides the following, similarly broad definition:

"The term *person* includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. The term also includes a guardian, committee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity." (Emphasis in original.)

This broad definition raises the question of whether a single-member LLC (SMLLC) that is disregarded for federal income tax purposes,[45] or a joint-ownership arrangement that is not treated as a separate entity for federal income tax purposes,[46] is intended to be treated as a "person" that is eligible to apply for and receive a grant. This question is not a frivolous one.

Only a *taxpayer* can claim a credit, so what needs to be determined under Section 45 is whether a taxpayer that seeks to claim a PTC is a "person" that is entitled to a credit under Section 45. Section 45(a)(2)(B) allows a credit based on an amount of electricity "sold by the taxpayer," and generally requires that the electricity be produced by a "facility owned by the taxpayer."[47] It is clear that, even if an SMLLC is treated as a "person" within the meaning of Section 45 (as Section 7701(a)(1) suggests it should be), the SMLLC is nonetheless disregarded in determining the identity of the *taxpayer* that is eligible to claim the credit.

There is no reason to assume that such is the case in connection with a payment of cash under the grant program, however. SMLLCs are disregarded in determining income tax liabilities, but they are not disregarded, even within the income tax system, as legal entities.[48]

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44 For example, Section 45(e)(3) states: "In the case of a facility in which more than 1 *person* has an ownership interest, except to the extent provided in regulations prescribed by the Secretary, production from the facility shall be allocated among such *persons* in proportion to their respective ownership interests in the gross sales from such facility." (Emphasis added.)

45 See Reg. 301.7701-3(b)(1)(ii).

46 See Reg. 301.7701-1(a)(2).

47 See, e.g., Section 45(d)(1) (defining "qualified facility" with respect to wind facilities). The ownership requirement does not apply to certain biomass facilities. In the case of such facilities, "the person eligible for the credit allowable under subsection (a) shall be the lessee or the operator of such facility." See Sections 45(d)(2)(C)(ii) (closed-loop biomass) and 45(d)(3)(C) (open-loop biomass).

48 See, e.g., Temp. Reg. 301.7701-2T(c)(2)(iv)(B), which provides: "Treatment of entity. An entity that is disregarded as an entity separate from its owner for any purpose under § 301.7701-2 is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code)." For other issues involving SMLLCs, see Sonnier and Lassar, "Tax Court Allows Valuation Discount for Membership Interest in Disregarded Entity," page 45, this issue.

There also are terms used in ARRA section 1603 that are not used in either Section 45 or 48 but are used in other provisions of the Code. For example, section 1603(g) uses terms like "political subdivision" and "instrumentality," which are not used in either of the cross-referenced Code sections but have a long definitional history under the tax laws.[49] Similarly, section 1603(g) uses "partnership" and "partner," which are not used in either Section 45 or 48, but are defined in Section 7701(a)(2) and the Regulations thereunder.[50]

At least one other term—'person'—is used both in section 1603 and in Section 45 or Section 48 where the intention to use a parallel definition is less clear.

Finally, there are concepts that are implicit in ARRA section 1603 that do not involve actual terms used in that statutory provision. It is not clear whether those concepts necessarily apply to the grant program in the same manner as they would apply under Section 45 or 48. For example, although "own" does not appear in section 1603, the concept of ownership is arguably implicit in the provision. This raises questions such as the following: If one person places property in service and has legal title to the property, but a second person has a bundle of economic rights and obligations with respect to the property that cause that second person to be treated as the owner of the property for federal income tax purposes, which person is entitled to receive a grant with respect to the property?

The foregoing questions arguably are answered by the statement in the Conference Report that "[i]t is intended that the grant provision mimic the operation of the credit under section 48." That is, it can be argued that, where there is any doubt, terminology and concepts should be applied in a manner that causes the grant program to mimic the operation of the energy ITC as closely as possible.

Nevertheless, the quoted language from the Conference Report also can be interpreted only as a guide to Treasury as the agency charged with administering the grant program, rather than a guide to the courts as to the meaning of the statute. Thus, for example, if Treasury chooses to issue a grant to an applicant with respect to an eligible property without first asking whether a person other than the applicant has the benefits and burdens of ownership of the property, is it appropriate for a court to pursue that inquiry if Treasury later seeks return of the grant proceeds?

Recapture and Other Section 50 Rules

As noted above, ARRA section 1603(f) provides that "[i]n making grants under this section, the Secretary of the Treasury shall apply rules similar to the rules of section 50 of the Internal Revenue Code of 1986. In applying such rules, if the property is disposed of, or otherwise ceases to be specified energy property, the Secretary of the Treasury shall provide for the recapture of the appropriate percentage of the grant amount in such manner as the Secretary of the Treasury determines appropriate."

The reference to Section 50 may be interpreted in a variety of ways, including the following:

- The reference in section 1603(f) to "rules similar to the rules of section 50 ..." implies that Treasury has the discretion to adopt rules of its choosing that are within a range of rules that may reasonably be considered "similar to" the rules in Section 50, but the use of "rules" means that Treasury may do so only through an administrative rulemaking procedure.
- In administering the grant program (with or without rulemaking), Treasury may deviate from the rules in Section 50 and the Regulations thereunder as it chooses, as long as the rules implied by Treasury's administrative actions are "similar" to the rules that apply for tax purposes under Section 50.
- In administering the grant program, Treasury may deviate from the rules in Section 50 only where the context (grant rather than tax credit) makes it necessary to do so—that is, it may deviate procedurally but not substantively.
- All IRS pronouncements implementing Section 50 (or the provisions of prior law that Section 50 incorporates by reference) necessarily apply to projects potentially eligible for grants.
- IRS pronouncements implementing Section 50 or its predecessor provisions apply only to the extent Treasury incorporates them in new rules expressly applicable to grants.

Like ARRA section 1603(g), discussed above, section 1603(f) literally instructs Treasury as an administering agency and does not purport to provide a substantive rule governing grant recipients. As with section 1603(g), this raises the following question: What happens if Treasury makes a grant, later determines that, in making the grant, it failed to apply rules "similar to the rules of section 50," and seeks to recover the grant funds? The answer to this question is not clear.

TREASURY GUIDANCE

On 7/9/09, Treasury issued guidance under the grant program in the form of the following documents:

- A 20-page pdf file entitled "Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009— Program Guidance" (the "program guidance").[51]

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49 See, e.g., Rev. Rul. 57-128, 1957-1 CB 311, which identifies six factors to be taken into account in determining "the status of an organization as an instrumentality of one or more states or political subdivisions."

50 See Regs. 301.7701-2 and -3.

51 See www.treasury.gov/recovery/docs/guidance.pdf.

- A three-page pdf file entitled "Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009—Terms and Conditions" (the "terms and conditions").[52]
- A six-page sample application form (the "sample application"), which was updated on 7/30/09.[53]
- A seven-page pdf file that instructs CPAs regarding their responsibilities when certifying costs of a facility in connection with a grant application (the "CPA guidance"), which was updated on 9/11/09 and again on 9/24/09, and which includes (1) a brief set of instructions to CPAs, (2) a form of Independent Accountants' Report, and (3) a form of Agreed-Upon Procedures Report.[54]

The guidance does not take the form of an administrative rulemaking, and it does not appear that Treasury views the guidance as having the legal force of an agency's rules. Indeed, the introductory portion of the program guidance merely states: "This guidance *establishes the procedures for applying* for payments under the Section 1603 program and *is intended to clarify* the eligibility requirements of the program." (Emphasis added.)

Another section of the program guidance similarly states: "The property descriptions included in this Guidance are intended to assist applicants in determining if a property qualifies for funding. They are not intended to change the meaning of the terms as they are used in sections 45 or 48 of the IRC."

The function of the guidance as a set of internal guidelines for an agency's adjudicative function, rather than a set of "rules" intended to have legal force, is further suggested by the following statement in Section II of the program guidance: "When Treasury determines that the application does not qualify for payment, the applicant will be so notified. Such notification will include the reasons for the determination and will be considered the final agency action on the application." The first sentence in the foregoing passage—"When Treasury determines that the application does not qualify for payment"—emphasizes the *decision process.* Treasury could have used an alternative formulation emphasizing the content of the program guidance itself, such as, e.g., "If the applicant's property does not qualify for a grant under the rules in this guidance...."

In other words, a reasonable characterization of the program guidance is that it informs grant applicants of (1) the procedures they must follow in order to obtain grants and (2) the positions Treasury is likely to take in processing grant applications. The portions of the guidance that purport to set forth *substantive rules* to guide grant applicants and those that set forth the *procedures* adopted by Treasury are discussed separately, below.

Substantive Content

Features of the program guidance that, in the author's view, purport to establish or report *substantive* rules that Treasury will follow in processing grant applications are examined below. The legal and practical effects of these rules is discussed later in this article.

Beginning of construction; units of property; optional aggregation. Under ARRA section 1603(a)(2), property placed in service after 2010 may be eligible for a grant, but only if "construction of such property began during 2009 or 2010." This raises two questions:

1. What constitutes the beginning of construction of a property?
2. What is the item of property that must be examined?

The broad definition raises the question of whether a disregarded entity is intended to be treated as a 'person' eligible for a grant. This is not a frivolous question.

In answering the first question, the program guidance states as a general rule that "[c]onstruction begins when physical work of a significant nature begins." This general rule, and the detailed rules in the program guidance that follow it, generally import or are based on similar rules that have been applied in the past *for tax purposes* in connection with the commencement and/or termination of bonus depreciation and other tax benefits with respect to property placed in service after a specified date.[55]

The program guidance also provides a safe harbor under which "[a]n applicant may treat physical work of a significant nature as beginning 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...." This safe harbor also is based on precedent relating to tax rules, although the 5% safe harbor provided

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52 See www.treasury.gov/recovery/docs/energy-terms-and-conditions.pdf.

53 See www.treasury.gov/recovery/docs/Application.pdf.

54 See www.treasury.gov/recovery/docs/accountant-certification.pdf. Links to all of the Treasury guidance can be found at www.treasury.gov/recovery/1603.shtml.

55 See, e.g., Reg. 1.168(k)-1(b)(4)(iii)(B) and Temp. Reg. 1.179C-1T(b)(7)(iii)(B). The core concept in those Regulations, "physical work of a significant nature," has its origin in the transitional rules for the repeal of the investment tax credit and the accelerated cost recovery system by TRA '86. The 1986 Conference Report explained a portion of the transitional rules as follows: "The conference agreement does not apply to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of March 1, 1986 (December 31, 1985, for purposes of the investment tax credit) and (2) the construction or reconstruction began by that date. *For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts.* Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing." H. Rep't No. 99-841, 99th Cong., 2d Sess., II-56 (1986) (emphasis added).

in the program guidance is more generous than the 10% safe harbor provided by the Regulations in identifying property eligible for bonus depreciation.[56]

As to the second question (identification of units of property), the program guidance provides a mandatory aggregation rule and an optional aggregation rule. The mandatory rule provides that for "purposes of determining the beginning of construction of property or the date property is placed in service, all the components of a larger property are a single unit of property if the components are functionally interdependent." Components are considered to be "functionally interdependent" if "the placing in service of one component is dependent on the placing in service of the other component." By way of example, the guidance states that components of a wind turbine are functionally interdependent, but separate turbines on a wind farm are not.

Treasury may have some difficulty applying its functional interdependence rule in some circumstances, such as where capitalized costs are incurred to replace components of property that already have been placed in service. It is hoped that any lack of clarity will be resolved favorably to applicants by reason of the following statements in the program guidance:

"Qualified property includes expansions of an existing property that is qualified property under section 45 or 48 of the IRC.... Thus, if property is placed in service in 2009 at a qualified facility that was placed in service in an earlier year, only the basis of the property placed in service in 2009 is eligible for a Section 1603 payment."

Example: A wind turbine is placed in service in 2009. The turbine's generator is replaced in 2010, and the replacement cost is capitalized. Treasury might seek to interpret its own functional interdependence rule as making the replacement generator ineligible for a grant, on the ground that there is no separate unit of property that can be treated as placed in service in 2010. Nevertheless, the sentence in the program guidance regarding expansions of existing property suggests that Treasury intends the cost of the generator replacement to be eligible for a grant. Moreover, there does not appear to be any basis in the statute for denying a grant for the cost of the generator.

If the generator is replaced in 2011, rather than 2010, the result is less clear. Under ARRA section 1603(a)(2), it is necessary to establish a pre-2011 commencement of construction of *the property that is placed in service in 2011*. Under the program guidance, it could be argued that, since the entire turbine is treated as a single unit of property, the placement in service of the generator is a placement in service of property construction of which began before 2011. It is not clear whether Treasury will agree with this position.

The program guidance also provides the following *optional* aggregation rule: "The owner of multiple units of property that are located at the same site and that will be operated as a larger unit may elect to treat the units (and any property, such as a computer control system, that serves some or all such units) as a single unit of property for purposes of determining the beginning of construction and the date the property is placed in service."

The program guidance also states that, if an applicant elects to aggregate multiple units of property so that construction of the later-constructed units is treated as having begun before 2011, the denominator of the 5% safe harbor calculation will include the cost of all of the units.[57]

Original-user requirement. Section III of the program guidance states: "For an applicant to be eligible to receive a Section 1603 payment it must be the owner or lessee of the property and must have originally placed the property in service." Similarly, section IV.G of the program guidance states: "The original use of the property must begin with the applicant."

Treasury may have some difficulty applying its functional interdependence rule in some circumstances.

Consistently with the foregoing, section 3A of the sample application states: "If applicant did not or will not originally place the property in service do not continue with this application." Finally, section 2.A of the terms and conditions, which an applicant must sign under penalties of perjury, states: "The applicant is the owner or lessee of specified energy property that qualifies for funds under Section 1603 and is the original user of the property."

Clearly, Treasury does not intend to make a grant with respect to a property to an applicant that is not the original user of the property. Nonetheless, there is no statutory basis for this requirement.

Under ARRA section 1603(d)(1), property is treated as "specified energy property" if it is "qualified property" (within the meaning of Section 48(a)(5)(D)) that is part of a "qualified facility" (within the meaning of Section 45). There is no original-user requirement in Section 45, and there is no original-user requirement in Section 48(a)(5).

There also is no original-user requirement in the provisions in Section 48 that are incorporated by reference in ARRA sections 1603(d)(2) through (8). As noted above, the original-user requirement in Section 48 is contained in Section 48(a)(3)(B). That provision is one of three subparagraphs that impose special eligibility requirements on all of the categories of property described in Section 48(a)(3)(A). ARRA sections 1603(d)(2) through (8) refer directly to those categories of property and

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56 See Reg. 1.168(k)-1(b)(4)(iii)(B)(*2*).

57 Electing to use the optional aggregation will compel applicants to make difficult choices in some cases, as discussed later in this article.

do not incorporate the special eligibility requirements. As noted above, *one* of those requirements—that the property be subject to depreciation or amortization—is expressly imposed by the flush language at the end of section 1603(d). The other requirements, including the original-user requirement, are not.

Clearly, Treasury does not intend to make a grant to an applicant that is not the original user of the property. There is no statutory basis for this requirement.

In support of the original-user requirement in the guidance, Treasury might seek to rely on the following language in the Conference Report: "In general, the grant amount is 30 percent of the basis of the property that would (1) be eligible for credit under section 48 or (2) comprise a section 45 credit-eligible facility.... It is intended that the grant provision mimic the operation of the credit under section 48."[58]

At best, however, that language lends some support to an original-user requirement for the categories of specified energy property described in ARRA sections 1603(d)(2) through (8), as the applicant would not have been entitled to the ITC with respect to the basis of property described in Section 48(a)(3)(A) if it was not originally placed in service by the applicant.[59] But, as discussed above, the Section 48 eligibility rules for property that is treated as specified energy property under section 1603(d)(1)—namely, qualified property that is part of a qualified facility under Section 45—do not include the original-use requirement.

If Congress intended grants to be available only to subsidize the cost of newly constructed property, a technical correction may be appropriate.

Used parts. Section IV.G of the program guidance states, with respect to property that contains "used parts," that if "the cost of the used parts contained within a facility is not more than 20 percent of the total cost of the facility (whether acquired or self-constructed), an applicant will not fail to be considered the original user of property because the facility contains used parts."

Although this rule is not expressly drafted as a safe harbor, it has the effect of one. That is, nothing in the guidance states that an applicant constructing a facility which contains used parts accounting for *more than* 20% of its total cost will automatically fail the original-user requirement. It is not clear, however, whether Treasury will entertain an application from an applicant that claims to be the original user of the subject property while acknowledging that more than 20% of its cost is attributable to used parts.

Integral-part and same-site requirements. Section IV.I of the program guidance includes the following statements: "Specified energy property includes only tangible property (not including a building) that is an integral part of the facility.... Qualified property includes only tangible property that is both used as an integral part of the activity performed by qualified facility and located at the site of the qualified facility.... Property is an integral part of a qualified facility if the property is used directly in the qualified facility, is essential to the completeness of the activity performed in that facility, and is located at the site of the qualified facility."

Also, under section 1.3(b) of the agreed-upon procedures report that is required to be provided by an independent accountant in support of an application requesting a grant between $150,000 and $1 million (discussed in more detail, below), the applicant's accountant is required to attest that it has followed several specific procedures, including the following: "Review management's detailed calculation of costs (information request 3) to determine that such costs are in accordance with the requirements of Section 1603, specifically consider the following areas as explained in the program guidance: ... (b) Costs are for tangible property (not including a building) which is an integral part of the facility."

As with the original-user requirement, the position taken in the guidance lacks statutory support.

As noted above, there are two basic categories of "specified energy property" under ARRA section 1603 (d). One category consists of "qualified property" that is part of a "qualifying facility" within the meaning of Section 45. The other category consists of seven types of property described in Section 48(a)(3)(A). The *only* reference in either Section 45 or 48 to property that is an "integral part" of a facility is in Section 48(a)(5)(D)(i)(II), which provides that "qualified property" includes "other tangible property (not including a building or its structural components)" only if the property is "used as an integral part of the qualified investment credit facility." The "integral part" requirement *does not* apply to tangible personal property that is part of a qualifying facility under Section 45,[60] and it does not apply to *any* of the seven types of property described in Section 48 (a)(3)(A).

There also is no requirement in either Section 45 or 48 that any property be located at the "same site" as any other property in order to be eligible for the ITC.

As noted above, Regulations under former Section 48(l) include certain same-site requirements for the category of energy property referred to in the Regulations as "handling and preparation equipment." Those Regulations provide the following rule, for example: "Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock."[61]

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58 See note 43, *supra*.

59 Section 48(a)(3)(B).

60 See, however, Notice 2009-52, *supra* note 35, which purports to apply an integral-part requirement to all property with respect to which a taxpayer makes an election under Section 48(a)(5)(C).

61 Reg. 1.48-9(c)(9)(i).

Those Regulations, however, were based on the following language (describing a category of "alternative energy property") in former Section 48(l)(3)(vii), which unequivocally imposed a same-site requirement: "equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation (including, but not limited to, washing, crushing, drying, and weighing) *at the point of use* of an alternate substance for use in equipment described in clause (i), (ii), (iii), (iv), (v), or (vi)...." (Emphasis added.)

In sum, as a purely technical matter, the integral-part requirement (except with respect to "other tangible property" at Section 45 qualifying facilities) and the same-site requirement are on shaky ground.

Eligible applicants. As noted above, ARRA section 1603(g) provides that Treasury is not to make grants to specified types of exempt and governmental entities. Included on that list is "any partnership or other pass-thru entity any partner (or other holder of an equity or profits interest) of which is" one of the other specified types of entities.

The meaning of "holder" and "equity or profits interest" is unclear, and the program guidance indicates that Treasury has determined that a partnership or "other pass-thru entity" is ineligible to receive a grant if any "*direct or indirect* partner (or other holder of an equity or profits interest)" of the entity is one of the entities listed in ARRA sections 1603(g)(1) through (3) (emphasis added).

Having so determined, Treasury has also stated: "Having as a direct or indirect partner, shareholder, or 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-thru entity." Thus, Treasury will make a grant to a partnership even if an interest in the partnership is held by a C corporation "blocker" owned by an exempt organization.[62]

It is not clear whether the foregoing rule in the guidance can be assumed to apply to a partnership of which a partner is a corporation owned by a governmental entity. Corporations owned by governmental entities are often treated as "instrumentalities" under judicial and administrative precedents. Rev. Rul. 57-128, 1957-1 CB 311, states:

"In cases involving the status of an organization as an instrumentality of one or more states or political subdivisions, the following factors are taken into consideration: (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses."

Nothing in the program guidance suggests that an applicant has any recourse to administrative reconsideration.

Not all corporations that are treated as government instrumentalities under Rev. Rul. 57-128 and related authorities are exempt from tax. Whether an instrumentality is tax exempt depends on whether it satisfies the requirements of Section 115 or 501.[63] It is possible that, even if a government-owned corporation is considered to be an instrumentality, its ownership of an interest in a partnership will not cause the partnership to lose its eligibility for a grant, by reason of the "taxable C corporation" rule in the program guidance, as long as it files Form 1120 and does not purport to be exempt from tax.

Section 168(h)(2)(D) provides that, for purposes of Section 168(h), "a corporation shall not be treated as an instrumentality of the United States or of any State or political subdivision thereof if—(i) all of the activities of such corporation are subject to tax under this chapter, and (ii) a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof." Arguably, ARRA section 1603(f) requires this provision to be taken into account in determining the eligibility for grants of a government-owned entity (or a pass-thru entity of which such an entity is an owner).

As noted above, section 1603(f) requires Treasury to apply rules similar to the rules in Section 50 in making grants, and Section 50(b)(4)(E) refers to Section 168(h) for "special rules for the application of this paragraph." The principal rule provided by Section 50(b)(4)(A) is that "[n]o credit shall be determined under this subpart with respect to any property used—(i) by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing...." Thus, it may be argued that Congress intended that a corporation satisfying the requirements of Section 168(h)(2)(D) would not be treated as a government instrumentality for purposes of ARRA section 1603(g)(1). The rule embodied in Section 168(h)(2)(D) is not expressly incorporated in the program guidance, however.

Partnerships, LLCs, and other

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62 The program guidance does not incorporate the rules of Section 168(h)(6)(F). Thus, a C corporation blocker need not make an election under Section 168(h)(6)(F)(ii) in order to be treated as a taxable corporation for this purpose. For more on the use of blockers generally, see Kwon, "Exempt Entity Investments in Private Equity Funds: Blockers vs. U.S. Partnerships," 109 JTAX 49 (July 2008).

63 For a thoughtful discussion of issues relating to the tax classification and tax treatment of government instrumentalities, see Aprill, "The Integral, The Essential, and The Instrumental: Federal Income Tax Treatment of Governmental Affiliates," 23 J. Corporation L. 803 (Summer 1998).

joint ventures with potentially ineligible equity participants that are scrambling to establish eligible structures as they complete the construction of projects involving specified eligible property will benefit from the following sentence in the "applicant eligibility" section of the guidance: "Applicant eligibility will be determined as of the time the application is received." Under this rule, for example, if a partnership with a tax-exempt partner places specified energy property in service, the partnership still may be eligible for a grant as long as the tax-exempt partner transfers its interest to an eligible person (such as a C corporation blocker) before the partnership submits its grant application to Treasury.

The determination of eligibility as of the application date also may provide applicants with an opportunity to avoid the original-use requirement in the guidance in some circumstances. For example, if a developer constructs specified energy property "on spec" and places it in service before a buyer is located, Treasury may determine that a buyer of the property itself does not satisfy the original-user requirement. If, however, the developer constructs the project in a partnership and then causes the partnership interests to be sold to persons controlled by the buyer, the partnership may then apply for a grant and reasonably take the position that it is the original user of the property. Although the partnership may be treated as terminating for tax purposes under Section 708(b)(1)(B), there is nothing in ARRA section 1603 that suggests that this tax rule must be taken into account.

Moreover, if the partnership has in effect an election under Section 754, the basis of the partnership's property immediately after the sale of the partnership interests should be increased by Section 743(b). Since the amount of a grant is expressly based on the "basis" of specified energy property, and ARRA section 1603 does not specify that the basis of property must be determined as of the time it is placed in service (as opposed to the time the application for the grant is submitted), it should be reasonable to request a grant using the basis as adjusted under Section 743(b). If that position is accepted, the cost attributable to the developer's profit will become part of the base for determining the grant, an outcome that cannot be considered unreasonable.

Tax-exempt use property. As noted above, by reason of Sections 50(b)(3) and (4), and cross-references in Section 50(b)(4) to Section 168(h), property leased to a tax-exempt or governmental entity generally is not eligible for the ITC. In light of the statement in ARRA section 1603(f) that, in making grants, Treasury "shall apply rules similar to the rules of Section 50," it would not have been surprising if the guidance had provided that grants are not permitted with respect to specified energy property that is leased to, or otherwise used by, an exempt or governmental entity.

The guidance provides no such rule. Moreover, Treasury representatives have stated publicly and via e-mails that the omission is intentional. That is, Treasury intends to make grants with respect to property used by exempt or governmental entities.[64]

Recapture. Under Section 50(a)(1)(A), all or a portion of the ITC allowed with respect to a property is recaptured if, before the close of the recapture period, the property "is disposed of or otherwise ceases to be investment credit property with respect to the taxpayer."

The guidance provides a recapture rule for grants that is considerably more liberal than the recapture rule in Section 50(a)(1)(A). Under section VII of the program guidance, a grant with respect to a property generally is recaptured only if, during the five-year recapture period, "an interest in the property or in the applicant or in any partnership or pass-thru entity that is a direct or indirect owner of an interest in the applicant is sold to" a person that is ineligible to be an applicant.[65]

Section VII of the program guidance further states: "Selling or otherwise disposing of the property to an entity other than a disqualified person does not result in recapture provided the property continues to qualify as a specified energy property and provided the purchaser of the property agrees to be jointly liable with the applicant for any recapture."

Recapture also occurs if, during the five-year recapture period, the property ceases to be eligible as specified energy property.

Procedural Content

The only procedures established or suggested by ARRA section 1603 are implied by the following three references to "applications":

1. ARRA section 1603(a) says that a grant shall be made "upon application."

2. ARRA section 1603(c)(1) provides that the "date of the application" may begin the 60-day period during which the grant must be made.

3. ARRA section 1603(j) provides that Treasury shall not make a grant to a person "unless the application of such person for such grant is received before October 1, 2011."

In the guidance, Treasury adopted detailed procedural rules for the grant program. Certain of those rules are discussed below, with a focus on those that may have a significant impact on the ability of some applicants to receive grants.

Two-step application process. Since property that is placed in service as late as 12/31/16 may be eligible for a grant, the 9/30/11 statutory application deadline makes a two-step application process inevitable. The guidance provides the following rules implementing a two-step process:

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64 An e-mail to the author from Treasury's e-mail address (1603Questions@do.treas.gov) states, in part: "... the eligible applicant (lessor) can lease to a tax exempt entity."

65 It is not clear why this passage in the program guidance uses "sold" rather than a broader term such as "transferred," "disposed of," or "sold or exchanged."

- An application for property that is placed in service in 2009 or 2010 must be submitted[66] after the property is placed in service and before 10/1/11.
- An application for property that has not been placed in service as of the end of 2010 but as to which construction began in 2009 or 2010 must be submitted after construction begins and before 10/1/11. Of course, if the property is placed in service before 10/1/11, the applicant may be able to file a complete application (a "final application") by that date. Otherwise, the applicant must submit what is referred to in this article as a "preliminary application."
- If a preliminary application is submitted with respect to a property, the applicant must submit a completed final application within 90 days after the property is placed in service.[67]

The program guidance states that Treasury will review preliminary applications and "notify the applicant if all eligibility requirements that can be determined prior to the property being placed in service have been met." This suggests that a preliminary application may be a vehicle for determining whether Treasury believes that the property, as described in the preliminary application, meets the requirements of specified energy property, and/or that Treasury agrees that the applicant is eligible to receive a grant (if detailed information about the structure and ownership of the applicant is provided).

Nevertheless, the program guidance does not state that Treasury will respond to a preliminary application within any particular time. Moreover, in reply to an e-mail inquiry from the author about the timing and nature of a Treasury response to a preliminary application, a Treasury representative wrote: "Treasury does not have a specific time frame in which to notify applicants of beginning construction projects. As a practical matter, the only eligibility factor which Treasury can confirm for such projects is that they have begun construction." Based on this limited information, an applicant cannot expect to receive any useful feedback in response to a preliminary application.

Once Treasury receives a final application, it will respond in one of three ways:

1. Treasury may notify the applicant that the application has been approved, in which case it will make a payment to the applicant within five days of the notice.

2. Treasury may notify the applicant that "the applicant has not submitted sufficient information upon which a determination can be based." Following such a notification, the applicant has "21 days from the date of the notice to submit additional information." If the applicant does not submit additional information within that period, the application will be denied.

3. Treasury may simply determine that "the application does not qualify for payment." In that event, it will notify the applicant of the reasons for its determination.

The program guidance states expressly that a notification described in the immediately preceding paragraph "will be considered the final agency action on the application." The program guidance does not contain a similar statement regarding the denial of an application following the submission of requested additional information, but there is nothing in the guidance to suggest that an applicant has any recourse to administrative reconsideration in such a situation. In reply to an e-mail inquiry from the author, a Treasury representative wrote: "While Treasury will make every effort to work with an applicant during the review process to ensure that the applicant has the opportunity to address any deficiencies in its application, once a determination is made, that determination is final. No administrative appeal is available."

Documentation. A considerable amount of documentation must be submitted with a grant application. Sections II.H and V of the program guidance describe the required documentation in considerable detail. The documentation falls into three categories:

1. Documentation of the eligibility of the subject property.

2. Documentation of the placement in service of the property.

3. Documentation of the cost of the property.

In general, the documentation required to obtain a grant for a property is similar to the documentation that a taxpayer might expect to provide in connection with an intensive IRS audit following a claim of a tax credit with respect to the property.

The application process does not require the applicant to provide any documentation to establish that the applicant is eligible to receive a grant.

Documentation of applicant's eligibility. The application process does not require the applicant to provide any documentation to establish that the applicant is eligible to receive a grant. Section 1A of the application

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66 All applications for grants must be submitted online at treas1603.nrel.gov/. The online filing system requires the applicant to establish a username and password. Those identifying data are used to file the application under penalties of perjury. An applicant must have a Data Universal Numbering System number obtained from Dun and Bradstreet to submit an application and must be registered with the Central Contractor Registration to receive a grant payment.

67 The program guidance contains confusing statements to the effect that Treasury will review preliminary applications and then "notify the applicant if all eligibility requirements that can be determined prior to the property being placed in service have been met." If so notified, the guidance states, the applicant must then provide supplemental information within 90 days after the placed-in-service date. This timeline ignores the possibility that Treasury will not respond to a preliminary application until more than 90 days after the property is placed in service. To be safe, applicants should not delay submission of a final application more than 90 days after the property is placed in service.

("Type of Applicant") presents the applicant with 12 categories of entity (including "Other") and instructs the applicant to "indicate which choice best describes the applicant." No supporting documentation is requested. This raises interesting questions with which some applicants will have to grapple.

Suppose, for example, that the applicant is a partnership and that one of its partners is a C corporation, wholly owned by a governmental entity, that intends to file Form 1120. Suppose further that the corporate partner satisfies a number of the criteria that are taken into account in characterizing a corporation as an "instrumentality" of a government. One of the entity choices is the following:

"Partnership or pass-thru entity with a government or any political subdivision, agency, or instrumentality thereof, 501(c) organization, or 54(j)(4) entity as a direct or indirect partner (or other direct or indirect holder of an equity or profits interest)—do not continue with application [Note: If such entity only owns an indirect interest in the applicant through a taxable C corporation—do not choose this selection.]"

If the applicant believes that its government-owned corporate partner is a taxable C corporation, is there any reason that the applicant should not simply state that it is a "partnership?" The answer to this question must take the following considerations into account:

1. Under ARRA section 1603(g), although Treasury is directed not to make grants to applicants in an ineligible category, the statute does not say that such applicants are ineligible to receive grants.

2. Since the application form expressly asks the applicant to "indicate which choice best describes the applicant," a question format that allows for uncertainty, an applicant that is not uncertain is not misrepresenting any facts by making a favorable judgment.

3. The fact that Treasury has not asked for documentary support for the applicant's claimed status can be viewed as indicating that Treasury does not intend to seek the return of grant funds from applicants that arguably are ineligible but that filled out the application in good faith.[68]

Documentation of eligible costs. The level of documentation required to establish the eligible cost of property depends on the size of the grant requested. Section V of the program guidance states:

"Applicants must submit with their application for a Section 1603 payment documentation to support the cost basis claimed for the property. Supporting documentation includes a detailed breakdown of all costs included in the basis. Other supporting documentation, such as contracts, copies of invoices, and proof of payment must be retained by the applicant and made available to Treasury upon request. For properties that have a cost basis in excess of $500,000 applicants must submit an independent accountant's certification attesting to the accuracy of all costs claimed as part of the basis of the property."

The CPA guidance published on the Treasury website provides more information about the nature of the independent accountant's certification referred to in the passage quoted above. Under the CPA guidance, the nature of the accountant's certification depends on the size of the requested grant. If the applicant is requesting a grant of $1 million or more (i.e., the eligible costs of the specified energy property are determined to be more than $3,333,333), the applicant must submit an "examination opinion" from an independent accountant "attesting to the accuracy of costs claimed as part of the basis of the property" (an "attest opinion").

If, however, the applicant is requesting a grant that is less than $1 million but greater than $150,000 (the grant amount resulting from an eligible cost basis of $500,000), the applicant must submit "a report of Agreed Upon Procedures (AUP) prepared by an independent accountant in accordance with AT Section 201, Agreed Upon Procedure Engagements (Statements on Standards for Attestation Engagements 10, as amended) of the AICPA" (an "eligible cost AUP").

It is not improper for a taxpayer to *claim* a credit with respect to property with respect to which a grant is being *applied for.*

The CPA guidance provides templates for (1) the attest opinion, (2) the "Report of Management on Eligible Cost Basis" on which the attest opinion is based, and (3) the eligible cost AUP. While the required accountant support for requested grants of $1 million or more does not require the accountant to make any judgments about the eligibility of the subject property, the required accountant support for smaller requested grants does include such a requirement. The following features of the CPA guidance give rise to this discrepancy.

The template in the CPA guidance for the attest opinion states that the accountant has examined the assertion by the applicant's management in the "Report of Management on Eligible Cost Basis" and has determined that "management's assertion ... is fairly stated, in all material respects based on the general rules for determining the basis of property for federal income tax purposes, as further described in Section V of the Program Guidance...."

The template for the Report of Management on Eligible Cost Basis states that "the cost basis of property eligible for the Payments for Specified Energy Property in Lieu of Tax Credits pursuant to Section 1603 of the American Recovery and Reinvestment Act of 2009 ... has been determined in accordance with the general rules for determining the basis of property for federal income tax purposes as further described in

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68 The author has not sought informal guidance from Treasury on this point.

Section V of the Program Guidance...."

The focus of these two statements is on the determination of cost. There is only one reference to "eligible" property, contained in the management report, and the accountant is not required to opine on management's adherence to eligibility rules in the guidance, except to the extent they are contained in Section V of the program guidance. Section V, however, does not refer to eligibility of property.[69] Thus, it does not appear that issues relating to the eligibility of property as specified energy property must be addressed under the procedures for certifying cost basis for requested grants of $1 million or more.

By contrast, the template in the CPA guidance for an eligible cost AUP includes the following requirement among the agreed-upon procedures that must be performed by the accountant: "Review management's detailed calculation of costs (information request 3) to determine that such costs are in accordance with the requirements of Section 1603, specifically consider the following areas as explained in the program guidance:

"(a) Used Parts.

"(b) Costs are for tangible property (not including a building) which is an integral part of the facility.

"(c) Only specified energy property is taken into account.

"(d) Qualified property that generates electricity excluding any electrical transmission equipment.

"(e) Specific property requirements.

"(f) Lessee and Lessee in a Sale-Leaseback."

Thus, it is possible that an accountant engaged to provide an eligible cost AUP may be required to address issues that are not within the scope of the engagement of an accountant providing an attest opinion.

Terms and conditions. Under the guidance, as a condition of receiving a grant, an applicant is required to sign and submit a form document titled "Terms and Conditions." The signed document is made a part of the application by means of a cross-reference in the application form.

Section 2 of the terms and conditions requires the applicant to affirm that the applicant is eligible to receive a grant and to acknowledge that Treasury is relying on information supplied by the applicant to determine the applicant's eligibility.

Sections 3 and 8 of the terms and conditions include provisions that relate to possible forfeiture of grant funds that have been received.

Section 4 of the terms and conditions requires the applicant to affirm that "[t]he applicant will not claim a tax credit under section 45 or section 48 of the IRC with respect to the property described in the application." That provision is not properly based on the applicable statutes and may present an applicant with a quandary.

Section 48(d) provides, in part: "In the case of any property with respect to which the Secretary makes a grant under section 1603 of the American Recovery and Reinvestment Tax Act of 2009—(1) ... No credit shall be determined under this section or section 45 with respect to such property for the taxable year in which such grant is made or any subsequent taxable year." Thus, if a grant is *made* with respect to a property, a tax credit is not *allowable* under Section 45 or 48 with respect to the property. Nevertheless, it is not improper for a taxpayer to *claim* a credit with respect to property with respect to which a grant is being *applied for*. Moreover, the interaction of ARRA section 1603 and the tax credit provisions is a one-way street. Nothing in section 1603 causes a taxpayer that claims or receives a tax credit with respect to a property to be ineligible to receive a grant with respect to the property.

Of course, a taxpayer that applies for and receives a grant with respect to a property is not eligible to receive a tax credit with respect to the property, and a taxpayer that has received such a grant cannot properly claim such a credit. An applicant for a grant with respect to a property, however, cannot know in advance whether Treasury will make the grant. If Treasury determines that the applicant, or the property, is ineligible for the grant, nothing in section 1603 or the applicable tax credit provisions of the Code makes it improper for the applicant to claim a tax credit with respect to the property. For the same reason, there should be nothing wrong with claiming a credit on a protective basis while a grant application is pending.[70]

Section 5 of the terms and conditions requires a successful grant applicant to make annual reports to Treasury regarding the performance of the subject property for five years after the property is placed in service. Section 6 requires the applicant to provide an annual certification that no recapture event has occurred. The no-recapture certification appears reasonable, but it is not clear how the requirement of an annual performance report relates to the purpose of the grant program.

Section 9 of the terms and conditions requires an applicant to agree "that Treasury may publicly release the name of the applicant; the type, location, and description of the property that is the subject of the application; and the amount of funding provided." This will certainly rankle, but applicants must recognize that the grant program is not a tax program, and information relating to a grant application is not "return information" that normally is exempt from disclosure under Section 6103.

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69 Section V of the program guidance does state that the "eligible basis of a qualified facility does not include the portion of the cost that is attributable to a non qualifying [sic] activity," providing an example in which a biomass facility burns both biomass and another fuel. The statement, however, has no bearing on the determination of whether any property that is part of the facility is eligible to be treated as specified energy property.

70 In fact, it should not be necessary to identify the claim of a credit as "protective." If an application for a grant with respect to a property is pending when a return is filed, claiming a credit for the same property is reasonable. If the grant is received, the taxpayer may amend the return, but if the grant is not received, there is no reason the taxpayer should be in the position of having impliedly informed the IRS that Treasury determined that the taxpayer was not eligible for the grant.

"Election" of 5% safe harbor and aggregation of units of property. As noted above, Section IV.D of the program guidance states: "The owner of multiple units of property that are located at the same site and that will be operated as a larger unit *may elect* to treat the units (and any property, such as a computer control system, that serves some or all such units) as a single unit of property for purposes of determining the beginning of construction and the date the property is placed in service" (emphasis added).

It is impossible to predict with any degree of certainty what deference will be given to Treasury's interpretation of ARRA section 1603.

The program guidance does not elaborate on what it means to "elect." Nothing in the guidance appears to prevent an applicant from making this "election" after property is placed in service and the applicant is filing an updated application. Section II of the Program Guidance states: "If an applicant is applying for Section 1603 payments for multiple units of property that are treated as a single, larger unit of property (see Section IV.D. below), all such units *may* be included in a single application" (emphasis added). Use of "may" suggests that filing separate preliminary applications for each unit does not preclude the applicant from treating the units as a "single, larger unit of property" at a later time. Nevertheless, section 4B of the application ("Narrative Description of Property") states: "If applying for multiple units of property that are being treated as a single, larger property, so indicate in the narrative."

It is not clear what effect this instruction is intended to have. It certainly is *not* intended to cause the property to fail to qualify for a grant if the "single, larger property" is not fully placed in service by the applicable credit termination date. Section IV.D of the Program Guidance states: "In cases where the applicant treats multiple units of property as a single unit, failure to complete the entire planned unit will not preclude receipt of a Section 1603 payment. For example, in the example noted above if only 40 of the planned 50 turbines were placed in service by the credit termination date, an otherwise eligible applicant would be eligible for a payment based on the 40 turbines placed in service."

Possibly, Treasury intends the description of the combined units in a preliminary application to act as a limitation on the safe harbor (i.e., to prevent the safe harbor from applying unless the applicant incurs 5% of the *estimated* cost of the combined units before the end of 2010). Nothing in the guidance actually says this, however.

It also is possible Treasury will take the position that an applicant that is planning an integrated, multi-unit facility and has placed some of the units in service—and applied for a grant for those units—cannot seek a grant for additional units when they are later placed in service. In such a situation, Treasury may take the position that, since the smaller aggregate was treated as a single unit of property that has already been placed in service, later-constructed units cannot be treated as part of that same unit, and construction of those later-built units therefore cannot be treated as having begun when construction of the smaller aggregate began.

The following e-mail message received by the author from a Treasury representative indicates that Treasury will take the latter position: "If an applicant elects to treat multiple units of property as a single unit of property for purposes of determining the start of construction then the applicant may only submit one application for that property. Alternatively, the applicant can treat each phase of the property as a separate property and submit separate applications for each phase. Costs claimed to demonstrate the start of construction for one property cannot be included to demonstrate the start of construction on another property."

If Treasury adheres to this position, an applicant constructing a large, multi-unit facility over a lengthy time may have to choose between (1) maximizing the amount of grant funds (by describing a large aggregate in the preliminary application and delaying the final application) or (2) accelerating receipt of funds and maximizing the likelihood that the safe harbor will apply (by describing a smaller aggregate in the preliminary application and filing the final application when the smaller aggregate is in service).

GENERAL OBSERVATIONS

While the ARRA grant program is based on, and is intended to mimic, the ITC, the process of applying for a grant for a property and potentially having to resolve a dispute with Treasury about the eligibility of the applicant, the eligibility of the property, or the cost of the property is uncharted territory for most tax advisors. In helping clients work through the ARRA grant application process, it is a good idea for tax professionals to be mindful of critical differences between applying for a grant and claiming a tax credit.

The familiar process of using an investment-based, federal tax-credit subsidy might look something like this:

1. The taxpayer makes a tentative determination that the subject property is eligible for a tax credit and makes a tentative determination of the amount of the credit.
2. The taxpayer's advisors identify areas of uncertainty and help the taxpayer structure the investment in the property to minimize risks of ineligibility and to maximize eligible costs.
3. The taxpayer places the property in service and claims on its return an amount of credit based on the most favorable possible resolution of uncertainties. Possibly, the taxpayer obtains opinions of counsel to minimize its exposure to tax penalties and/or for other purposes.

4. At some time before the expiration of the applicable statute of limitations (normally, three years after the filing of the taxpayer's tax return for the tax year in which the credit was claimed[71]), an IRS agent may examine the taxpayer's return and raise questions about the amount of the claimed credit or the eligibility of the property for the credit.

5. The taxpayer provides requested information to the agent, possibly satisfying the agent's concerns.

6. If the agent does not agree with the taxpayer's position, the dispute may be moved to an IRS Appeals Officer.

7. The taxpayer seeks to persuade the Appeals Officer of the correctness of the taxpayer's position. If that effort is unsuccessful, the taxpayer and the Appeals Officer may agree to compromise the amount of the credit, based on "hazards of litigation" and/or actual concessions by one side or the other regarding points of fact or law. Advice from IRS Chief Counsel may be sought.

8. If the taxpayer and the Appeals Officer are unable to resolve the issue, the IRS issues a notice of deficiency. Possibly, the notice of deficiency reflects a smaller deficiency than that initially proposed by the agent.

9. The taxpayer then decides whether to pay the tax and drop the issue, pay the tax and seek a refund in a federal district court or the Court of Federal Claims, or petition the U.S. Tax Court for a redetermination of the deficiency.

10. In litigation, and in the taxpayer's negotiations with the IRS, the dispute is governed by (a) applicable provisions of the Code, (b) Regulations, (c) Revenue Rulings and other pronouncements, particularly those that favor the taxpayer, (d) tax doctrines of general applicability, and (e) a plethora of court cases interpreting applicable or analogous provisions in the Code and Regulations.

None of these familiar guideposts is available under the ARRA grant program. Under the grant program, the applicant applies for a grant, submitting an application and terms and conditions, both signed under penalties of perjury. Treasury makes a grant or denies the application. Denial of the application is considered by Treasury to be "the final agency action on the application." No administrative review processes are available. If the applicant wishes to dispute a denied application, the applicant must file a lawsuit.

If Treasury makes a grant to the applicant and subsequently determines that the grant should not have been made, Treasury will ask the applicant to return all or part of the grant proceeds. If the applicant does not agree, Treasury must file a lawsuit. It may be that the parties will negotiate in a manner similar to the manner in which a taxpayer and the IRS resolve a tax dispute, but it is unlikely that the negotiation will follow a familiar process.

Legal Effect of the Guidance

It is not possible to provide definitive answers regarding the legal effect of the guidance and the manner in which courts will resolve disputes between applicants and Treasury under the grant program. Some basic principles that are likely to be taken into account can be identified, however.

It is a matter of black letter law that federal agencies are given some degree of deference by the courts. The question of how much deference should be given, and under what circumstances, was addressed at length by the Supreme Court in *U.S. v. Mead Corporation,* 533 U.S. 218 (2001). In *Mead,* the Court, reviewing the application of its earlier holding in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984), held "that administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. Delegation of such authority may be shown in a variety of ways, as by an agency's power to engage in adjudication or notice-and-comment rulemaking, or by some other indication of a comparable congressional intent." Justice Scalia, dissenting in *Mead,* described it as an evisceration of the *Chevron* doctrine: "Today the Court collapses this doctrine, announcing instead a presumption that agency discretion does not exist unless the statute, expressly or impliedly, says so."

Cases dealing with judicial deference to agency action are legion, and, notwithstanding Justice Scalia's characterization of *Mead,* it is by no means clear that post-*Mead* decisions have presumed that agency discretion does not exist in the absence of a statutory mandate.[72] It is simply impossible to predict with any degree of certainty what deference will be given to the Treasury in its interpretation of ARRA section 1603. A few observations may be made, however.

First, it is generally accepted after *Mead* that agency interpretations of a statute that are adopted in formal rulemakings or adjudications are entitled to more deference than interpretations that do not follow from such procedures. Decisions made by Treasury in processing grant applications do *not* involve formal rulemaking, and the program guidance was *not* issued in a notice-and-comment rulemaking.

Second, section 553 of the Administrative Procedure Act (APA), 5 U.S.C. section 553, imposes a notice-and-comment procedure for federal agency rulemakings, and Treasury did not follow such a procedure in issuing the guidance. The effect of Treasury's failure to follow such a procedure is unclear, however. Under APA section 553(a)(2), the notice-and-comment requirement does not apply to matters involving "grants." It is not clear, however, whether the exception for "grants" encompasses substantive agency rules in connection with a statute that requires the

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[71] Section 6501(a).

agency to make grants on a nondiscretionary basis.[73]

Third, even if the notice-and-comment requirement does not apply to the guidance because it involves a grant program, the guidance may run afoul of APA section 552 (a)(1), which requires federal agencies to publish all procedural and substantive rules in the *Federal Register* and further provides:

"Except to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published. For the purpose of this paragraph, matter reasonably available to the class of persons affected thereby is deemed published in the Federal Register when incorporated by reference therein with the approval of the Director of the Federal Register."

The author has been unable to locate any reference to the guidance in the *Federal Register,* or even any reference to the grant program other than a notice in the 9/11/09 *Federal Register* that Treasury intended to submit to the Office of Management and Budget a proposal to collect certain information in connection with the grant program.[74] Thus, if a person seeking a grant is unaware of the guidance in time to comply with it on a timely basis, APA section 552(a)(1) may prevent Treasury from refusing to make a grant to that person for failure to follow the procedures established in the guidance.

Fourth, as noted above, the following statement in the program guidance suggests that Treasury does not *intend* the substantive portions of the guidance to have legal force: "This guidance ... *is intended to clarify* the eligibility requirements of the program" (emphasis added).

Other Sources of Authority for Treasury Positions

As noted throughout this portion of the article, the application process established by Treasury requires applicants to subscribe to certain statements in the application and the terms and conditions, and, at least in the case of requests for grants in amounts between $150,000 and $1 million, requires an independent accountant to attest to procedures that incorporate substantive provisions in the guidance. It is possible that Treasury will take the position that, by submitting these documents, an applicant cedes a degree of discretionary authority to Treasury.

For example, section 8.a of the terms and conditions states: "If the applicant materially fails to comply with any term of the award, whether stated in a Federal statute or regulation, program guidance, these Terms and Conditions, or a notice of award, Treasury may take any remedial action that is legally available including disallowing all or a part of the Section 1603 payment. Any payment that is disallowed must be returned to the Treasury."

Treasury might take the position that, if an applicant receives a grant with respect to a property, and Treasury later determines that the property is not eligible for a grant due to a substantive rule in the guidance, the applicant has materially failed to comply with a "term of the award." If Treasury takes such a position, Treasury also might argue that, by signing the terms and conditions, the applicant has contractually agreed that it will return the grant if notified by Treasury that the grant has been disallowed.

Unanswered Procedural Questions

At this time, there are numerous unanswered procedural questions that applicants and their advisors must face, including but not limited to the following:

- If Treasury, based on complete and accurate information provided by an applicant, decides to make a grant under circumstances in which it might legitimately have decided not to make the grant, does Treasury have any authority to recover the grant from the grantee?
- If Treasury makes a grant based on information provided to it and subsequently determines that the information did not fully disclose facts that would have caused Treasury not to make the grant, does Treasury have the authority to recover the grant from the grantee? Does the answer to this question depend on whether the application materials failed to ask the applicant for any information beyond what was provided?
- If an applicant receives a grant with respect to a property that is determined by reference to a cost basis that is less than the cost basis the applicant believes is correct, does the receipt of the grant cause the applicant to be ineligible for any credit under Section 48 with respect to the property? Does the answer to this question depend on whether the costs disallowed relate to discrete items of property that Treasury determined were not eligible as "specified energy property?"
- Does the statement in the terms and conditions that "[t]he applicant will not claim a tax credit under section 45 or section 48 of the IRC with respect to the property described in the application" have any legal effect on the applicant's ability to claim a credit if the application is denied or if the applicant receives a smaller grant than the amount requested?

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72 In a tax context, see generally Blankenship, "Determining the Validity of Tax Regulations—Uncertainties Persist," 107 JTAX 205 (October 2007), and Schnee and Seago, "Deference Issues in the Tax Law: *Mead* Clarifies the *Chevron* Rule—Or Does It?," 96 JTAX 366 (June 2002).

73 On 10/13/09, an Audit Report of Treasury's Office of Inspector General, titled "RECOVERY ACT: Treasury Should Ensure That Assessments of Staffing, Qualifications, and Training Needs Are Based on Reliable Survey Data," states (page 6): "Treasury did not require the Office of the Fiscal Assistant Secretary (OFAS) to complete the grants manager or project manager survey. This office, however, is responsible for administering nearly $20 billion in Recovery Act funds for grants in lieu of tax credits for specified energy property and low income housing. These amounts represent approximately 88 percent of the $22 billion of Recovery Act funds that Treasury is responsible for administering. *OFAS did not complete the surveys because it does not consider these programs to be grant programs.*" (Emphasis added.)

74 74 Fed. Reg. 46833.

Income Tax Issues: Partnerships and Corporations

Special accounting issues arise in connection with grants received by partnerships and corporations.

Partnerships. Section 705(a)(1)(B) provides that the adjusted basis of a partnership interest is increased by "income of the partnership exempt from tax under this title." In Rev. Rul. 96-10, 1996-1 CB 138, the Service stated: "In determining whether a transaction results in exempt income within the meaning of section 705(a)(1)(B) ... the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income."

Following this principle, if a partnership receives a grant, a partner's basis in its partnership should be increased by 50% of the partner's share of the grant, as the basis of the partnership's property must be reduced by the "other" 50% of the grant, and the latter 50% therefore does not have a permanent effect on the partnership's basis in its assets.[75]

Another question is whether a special allocation of the book income attributable to the grant will be respected for purposes of determining each partner's basis increase under Section 705(a)(1)(B). Under Regs. 1.704-1(b)(4)(ii) and 1.46-3(f), an ITC with respect to a property generally cannot be specially allocated, but must be allocated in accordance with (1) "the ratio in which the partners divide the general profits of the partnership"[76] or (2) the manner in which "all related items of income, gain, loss, and deduction with respect to [the] property" are allocated.[77] That requirement, however, is based on the following premise:

"Allocations of tax credits ... are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits ... give rise to capital account adjustments under paragraph (b)(2)(iv)(*l*) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section...."[78]

This premise is not true of grants, however. Unlike a tax credit, which has economic value only to a partner and cannot be part of partnership capital, a grant received by a partnership increases the capital of the partnership, and a special allocation of the grant can have an economic effect on the partners by affecting their right to current or future distributions. Accordingly, it should be permissible for a partnership to specially allocate among its partners the 50% portion of a grant that is reflected in a permanent increase in the basis of the partnership's property, and the partners should be entitled to take that allocation into account in adjusting the bases of their partnership interests under Section 705(a)(1)(B).

Corporations. If a grant is received by a C corporation, a question arises as to whether the amount of the grant is includable in the corporation's E&P. The answer depends on application of Reg. 1.312-6(b), which reads in part as follows:

"Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts."

A good argument can be made that this Regulation, like Section 705(a)(1)(B), should encompass only income that is permanently excluded from taxation, and not income that is merely deferred through the mechanism of a reduction of the adjusted basis of the taxpayer's property. The waters are muddied, however, by the fact that the Code contains provisions that expressly exclude some categories of deferred income from E&P. For example, Section 312(l)(1) states: "The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017."[79]

Practice Notes

Partnerships, LLCs, and other joint ventures with potentially ineligible equity participants that are scrambling to establish eligible structures as they complete the construction of projects involving specified eligible property will benefit from the following sentence in the "applicant eligibility" section of the guidance: "Applicant eligibility will be determined as of the time the application is received." Under this rule, for example, if a partnership with a tax-exempt partner places specified energy property in service, the partnership still may be eligible for a grant as long as the tax-exempt partner transfers its interest to an eligible person (such as a C corporation blocker) before the partnership submits its grant application to Treasury.

A grant received by a partnership increases the capital of the partnership, and a special allocation of the grant can have an economic effect on the partners.

An additional problem results from the statement in the ARRA Conference Report that the grant is intended to "mimic the operation of the credit under section 48." The ITC, as a reduction in federal in-

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[75] See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships & Partners,* Fourth Edition (Thomson Reuters/WG&L, 2008), ¶ 6.02[3][a].

[76] Reg. 1.46-3(f)(2)(i).

[77] Reg. 1.46-3(f)(2)(ii).

come tax, offsets the reduction of E&P by the federal income tax liability and is therefore, in effect, "included" in E&P.[80] In light of this, Section 312(k)(5) provides that, in computing E&P, depreciation is determined without regard to the Section 50(c) basis adjustment. It is not yet known whether the IRS will take the position that, in order to "mimic" the operation of the ITC, ARRA grants must be included in E&P with a corresponding increase of E&P depreciation under Section 312(k)(5).

CONCLUSION

The ARRA grant program raises many difficult questions, both technical ones regarding eligibility for grants and procedural issues regarding the effect of guidance from Treasury and the resolution of disputes. As with many investment subsidies based on the Code, it is likely that it will be many years before all of the questions are answered. ■

NEW DEVELOPMENTS

Defining a 'Security' for Purposes of Sections 165 and 166

The July and August 2009 issues of THE JOURNAL included articles by Michael J. Kliegman and Anna Turkenich, partners in the Mergers & Acquisitions Tax Group of PricewaterhouseCoopers LLP in New York City, discussing timing and character issues relating to worthless debt and to worthless stock or securities, respectively.[1] The authors focus below on how to identify a "security" for these purposes.

Taxpayers confronted with an underwater debt investment must often struggle with the question of whether the resulting loss will be subject to the fairly liberal bad debt provisions of Section 166 or the more restrictive provisions of Section 165. As discussed in our article in July,[2] it is well established that for a corporation, deductions with respect to wholly or partially worthless debt under Section 166(a)(1) or 166(a)(2) are ordinary in nature.

A bad debt deduction is not permitted under Section 166, however, for debt that constitutes a "security" as defined in Section 165(g)(2). Rather, under Section 165(g)(1), if a security that is a capital asset becomes wholly worthless at any time during the tax year, then the resulting loss is capital—that is, such loss is treated as a loss from the sale or exchange of a capital asset on the last day of that tax year (unless the affiliated corporation rules under Section 165(g)(3) are applicable).[3] Thus, absent a realization event, a taxpayer is not entitled to a loss on a security unless it is wholly worthless, in contrast to the bad debt rules under Section 166, which allow for a partially worthless deduction. Additionally, as noted above, unless the affiliated subsidiary rule of Section 165(g)(3) applies, a loss under Section 165(g) is typically capital.[4]

Section 165(g)(2) defines "security" as (1) a share of stock in a corporation, (2) a right to subscribe for or to receive a share of stock in a corporation, or (3) a bond, debenture, note, or certificate or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Thus, a debenture that is in registered form is a "security" under this definition, and therefore is subject to the loss provisions of Section 165(g) instead of the bad debt provisions of Section 166. In general, securities under Section 165(g)(2) may be of any term.[5]

Absent a realization event, a taxpayer is not entitled to a loss on a security unless it is wholly worthless, in contrast to the bad debt rules.

The term "security" can be found in many areas of the Code, and there are differing definitions for the same term in these various contexts. The definition of a security for purposes of Section 165 must be distinguished from "security" used in other areas of the Code.[6]

Background. Prior to 1939, when Congress enacted what is now Section 166(e), losses on worthless securities were treated as bad debts.[7] As such, when the redemption of a debt security generated a loss, such loss was deductible against ordinary income as a bad debt.[8]

In addition, the Regulations have provided since 1921 that a debt charged off pursuant to an order of bank supervisory authority is presumed to be worthless. As noted by one tax commentator, "[d]uring the Depression years, these two rules, operating together, generated large bad debt deductions for financial institutions, claimable against ordinary income, for tradable debt securities whose value had declined substantially."[9]

In order to minimize the revenue impact of these deductions, Congress adopted a provision—section 117(f) of the Revenue Act of 1934 (a predecessor of Section 1271(a) of the present Code)—to treat "amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, ... as amounts received in exchange therefor,"[10] and then enacted a predecessor of Section 166(e) to disallow a bad debt deduction with respect to a "security" as defined in Section 165(g)(2).

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78 Reg. 1.704-1(b)(4)(ii).

79 See Bittker and Eustice, *Federal Income Taxation of Corporations & Shareholders,* Seventh Edition (Thomson Reuters/WG&L, 2008), ¶ 8.03[3], for a general discussion of the effect on E&P of items excluded from taxable income.

80 See Rev. Rul. 63-63, 1963-1 CB 10 ("it would be inappropriate in computing earnings and profits to allow as a decrease thereto the gross amount of Federal income tax liability before reduction by the amount of the investment credit").

Issuer. The first criterion for a debt instrument to be treated as a security is that it must be issued by a corporation or by a government or political subdivision thereof. A partnership interest, by contrast, does not fall within the definition of a "security" as set forth in either Section 165 or the Regulations thereunder. Nevertheless, the IRS stated in a 1995 Field Service Advice that where a partnership holds securities as its sole or major asset, the result of which is to circumvent the restrictions of Section 165(g), the partnership itself may be ignored and any loss with respect to the partnership should be characterized as capital.[11]

Interest coupons. In *Allied Chemical Corp.,* 305 F.2d 433, 10 AFTR2d 5148 (Ct. Cl. 1962), the fact that corporate notes each bore a single interest coupon did not disqualify the notes from the definition of a security for purposes of Section 165. In *Allied Chemical* the taxpayer argued that since section 23(k)(3) (a predecessor of Section 165(g)(2)) defined "securities" as "notes" etc., "with interest coupons," and since the notes in question had only one coupon attached, they did not come within the definition.

The court disagreed and stated that "[t]he word 'coupons' embraces many, a few, or only one coupon." The plural form of the word "was used to embrace all notes with coupons attached, irrespective of how many coupons there might be." In fact, there is no authority that the word was "intended to exclude a note with only one coupon." On the facts of the case, the court held that the corporate notes, which matured in six months and had only one coupon attached, were "securities."

In registered form. The Regulations under Section 165 do not define "in registered form" with respect to Section 165(g)(2). The Second Circuit addressed the issue of what was meant by that phrase in *Gerard v. Helvering,* 120 F.2d 235, 27 AFTR 420 (CA-2, 1941). In the case of a bond, the court indicated that the phrase refers to being "'registered' upon the books of the obligor or of a transfer agent." The purpose of this "is to protect the holder by making invalid unregistered transfers, and the bond always so provides upon its face."

Following the Second Circuit, the Tax Court in *Estate of Martin,* 7 TC 1081 (1946), and *Funk,* 35 TC 42 (1960),[12] examined the predecessor of Section 165(g) in dealing with an issue of whether certain advances to a corporation were "in registered form" with the consequence that a deduction for the worthlessness thereof must be treated as a capital loss. Since the notes in *Funk* or installment investment certificates evidencing the debt in *Martin* were recorded and could be effectively transferred only in the books of the debtor, the court found that each obligation was in registered form and constituted a "security."

In *Funk,* the Tax Court stated that "[p]etitioner's contention that the reasons for casting the note in registered form in 1942 had ceased to exist by 1953" was irrelevant. "The fact is that the form of the note remained the same, and, whether petitioner desired it or not, the provision in the note relating to transferability on the books of the company continued 'to protect the holder by making invalid unregistered transfers.'"

In Rev. Rul. 66-321, 1966-2 CB 59, "loan agreements evidenced by numbered convertible debentures payable to a licensed company under the Small Business Investment Act or its registered assigns, or which require that such debentures be fully registered," also were treated by the IRS as "securities" as defined in Section 165(g)(2)(C). Therefore, Section 166, relating to bad debts, did not apply to debts evidenced by such loan agreements by reason of Section 166(e).

In addition to this common law authority, Section 165(j)(2)(B) provides that "registered form" has the same meaning as when used in Section 163(f)(2), which in turn refers to Section 149(a). The Regulations under Section 149(a) treat an obligation as "in registered form" if the rights to principal and interest are registered with the issuer and may be transferred only by surrender of the old instrument to the issuer, and/or through a book-entry system maintained by the issuer.

Similarly, for purposes of Sections 149 and 163(f), Reg. 5f.103-1(c)(1) (promulgated in 1982) provides that an obligation is in registered form if:

1. The obligation is registered as to both principal and any stated interest with the issuer (or its agent), and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the

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1 See Kliegman and Turkenich, "Debt Losses: Timing and Character Issues Revisited," 111 JTAX 8 (July 2009); Kliegman and Turkenich, "Worthless Stock or Securities: Timing and Character Issues Revisited," 111 JTAX 70 (August 2009).

2 See note 1, *supra*.

3 Sections 165(g)(1) and (3); Reg. 1.165-5(c).

4 Section 582(a) overrides Section 166(e) and allows ordinary, partially worthless losses for banks.

5 Section 165(g)(2)(C); Reg. 1.165-5(a)(3).

6 One such area is Section 354. There is no clear rule defining a security for purposes of Section 354. Although the determination depends on all the facts and circumstances, the single most important factor is probably the instrument's term to maturity at the time of issuance. In Rev. Rul. 59-98, 1959-1 CB 76, bonds with average life of 6.5 years were found to be securities for purposes of Section 354. In Pinellas Ice & Cold Storage Co., 287 U.S. 462, 11 AFTR 1112 (1933), notes payable in four months were not securities. In Sisto Financial Corp., 139 F.2d 253, 31 AFTR 1046 (CA-2, 1943), notes payable in six months were not securities; in Neville Coke & Chemical Co., 148 F.2d 599, 33 AFTR 1131 (CA-3, 1945), three-, four-, and five-year notes evidencing advances were not securities, while in Freund, 98 F.2d 201, 21 AFTR 681 (CA-3, 1938), bonds maturing serially over a six-year period were securities. Additionally, Section 475(c)(2) defines "Category C" securities as notes, bonds, debentures, or other evidences of indebtedness, while with respect to dealers in securities, Section 1236 (c) defines a security as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing."

7 Langbein, *Federal Income Taxation of Banks & Financial Institutions* (Thomson Reuters/WG&L, 2009), ¶ 3.03.

8 *Id.* See Pacific Nat'l Bank of Seattle, 91 F.2d 103, 19 AFTR 1072 (CA-9, 1937).

9 Langbein, *supra* note 7.

10 See further discussion in the July 2009 Kliegman and Turkenich article, *supra* note 1.

11 IRS FSA, 6/9/95 (1995 WL 1770877). See also IRS FSA, 2/3/92 (1992 WL 1355739).

12 See also Oestreicher, 20 TC 12 (1953).

issuer of a new instrument to the new holder,

2. The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent), or

3. The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in (1) and (2).

An obligation that does not meet the requirements under Reg. 5f.103-1(c)(1) is considered to be in bearer form. An obligation is not considered to be in registered form if it can be transferred at any other time by means that vary from those described in Reg. 5f.103-1(c)(1). In that event, if the obligation is later modified so as to meet the above requirements with regard to transfers until its maturity, the obligation would be considered in registered form as long as those conditions are met.

The conversion of an instrument described in Section 165(g)(2)(C) from registered to unregistered form is effective when the registration language is actually removed from the instrument, not when the agreement to change the status of the instrument is entered into. Thus, in Rev. Rul. 73-101, 1973-1 CB 78, X corporation, in the course of its business, made bona fide loans to certain corporations, which issued debentures in registered form to X as evidence of the loans pursuant to the terms of formal loan contracts between the parties. The parties agreed on 12/1/70 to change the debentures from registered form to unregistered form. On 1/31/71, the provisions of registration were physically deleted from the debentures and underlying loan contracts.

The IRS stated in the Ruling that, as demonstrated in *Funk,* "[i]n determining whether an instrument is in registered form, it is the form of the instrument, not the intention of the parties, that controls." As long as the instrument reflects the provisions of registration (e.g., that the instrument must be registered in the name of the new owner to be transferred validly), the instrument remains in registered form. Accordingly, the Service concluded that the debentures in the Ruling were changed from registered form to unregistered form when the provisions of registration were actually removed from the face of the debentures and the underlying loan contracts on 1/31/71.

Conclusion. As discussed above, Section 166(e) provides that the rules of Section 166 do not apply to a debt that is evidenced by a "security" as defined by Section 165(g)(2)(C). The focus of the Section 165(g)(2)(C) definition of a security is that the instrument be "issued by a corporation ... with interest coupons or in registered form." The determination of whether an instrument falls within or outside this definition has important consequences as to the timing and character of a tax loss with respect to it. The tax professional seeking to advise a client in this area must, unfortunately, embark on a fairly meandering journey to determine the instrument's character. ■

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