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### Update: Financing Renewables with Treasury Grants

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The financial crisis spawned two major stimulus packages in the U.S. that have reshaped the federal policy landscape for renewable power. Most notably, qualifying solar, wind and other renewable energy generation projects can choose either a 30% investment tax credit ("ITC") or a 30% cash grant in lieu of the ITC (so-called "section 1603 grants"). Wind and other non-solar projects formerly eligible only for the production tax credit ("PTC") can for a limited time elect any of the PTC, the ITC or the cash grant. To qualify for the cash grant, projects must either be operational (placed in service) by the end of 2010 or else must begin construction by then and be placed in service by the end of 2012 for wind and by the end of 2016 for solar. To learn more about the program, visit the U.S. Treasury Web site. Please also view our summary of the program.

There is no cap on the amount of cash grants in lieu of tax credits that can be paid by Treasury under this program. A fairly simple statute and on-line application process has made this program a success. As of this writing the Department of Treasury has paid or allocated over \$2 billion in cash grants under this program. Most of the money has gone to large scale wind projects that had been completed or were "shovel ready" when the program opened. Many solar projects have also benefited from this program, including commercial and municipal distributed generation. Financings of large utility-scale projects also are being arranged around the availability of the grant.

Treasury has not published detailed formal written guidance on the grant program since the inception of the program in July 2009. Much of the guidance has been anecdotal, frequently comments made by IRS officials at conferences or reports of comments made or positions taken by the IRS in the applications process. In January, however, The Treasury Department released "Frequently Asked Questions and Answers" ("FAQs") providing supplemental guidance under the cash grant program.

#### Tax-Exempt Entities

The most significant FAQs relate to tax-exempt entities, which include schools, colleges, charitable organizations, state and local governments and agencies, and some foreign persons. These entities typically are not owners of energy projects and could not benefit from the ITC if they owned the project. The FAQs confirm that tax-exempt entities are not themselves eligible for the cash grant. The ITC also is not allowed for a project that is owned by one party and leased to a tax-exempt entity. However, if the tax-exempt merely purchases the power generated by the

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- Articles & Publications
- News Releases
- Press Coverage

#### Events

- Firm Events
- Sponsored Events

project under a power purchase agreement (“PPA”), then the owner may claim the ITC. For this reason, many financings of distributed generation projects with municipal or other tax-exempt customers are structured as PPAs rather than as leases. Under a common structure, a third party tax equity investor is the owner of the project under a sale-leaseback with the developer-lessee, who in turn sells the power to the tax-exempt customer under a PPA.

In a significant variation from the ITC rules, the FAQ provides that the cash grant is available to the owner of a project leased to a tax-exempt entity. Rooftop solar companies will be able lease rooftop systems to public schools and government agencies without losing the cash grant. However, there will be loss in tax depreciation benefits, because all assets leased to tax-exempt entities are subject to a slower tax depreciation allowance. A solar project leased to a tax-exempt is depreciated over 12 years (or 125% of the lease term if longer) on a straight-line basis rather than over five years on an accelerated basis. Other tax constraints on tax-exempt entity leasing may have to be satisfied to avoid further reductions in depreciation deductions. From a tax standpoint, to avoid a loss of depreciation deductions, it is still preferable to enter into PPAs with tax-exempt entities, rather than lease the project to them, to avoid a loss in the depreciation benefits. Such transactions must be structured carefully to ensure that for tax purposes the lease qualifies as a “true lease” and the PPA is classified as a service contract and not a lease. However, the parties may prefer a direct lease for non-tax reasons.

The relaxation of the ban on cash grants for tax-exempt leasing may also help projects designed for ownership by a partnership that includes members that are tax-exempt entities. Under current guidance, a project that is owned by a partnership does not qualify for the cash grant if any interest in the partnership – no matter how small or remote – is owned by a tax-exempt or other ineligible entity. Some unique types of tax-exempt entities that are experienced power players, such as municipal utilities and electric cooperatives, may wish to enter into partnerships with developers under which the partnership would sell, lease back, and operate the project. The new rule will allow that project to benefit from a full cash grant.

However, the FAQ does not change the rule that if a partnership is the owner (rather than a lessee) no cash grant is available if there is any tax-exempt ownership interest in the partnership. Most private equity funds have at least some tax-exempt entities as investors. Market participants have been pressing Congress to eliminate this rule, or at least rewrite it so that partial ownership of a partnership by government or other tax-exempt entities would not lead to a loss of the entire grant, but loss of only that portion of the grant that is proportional to the tax-exempt entity's interest in the partnership.

#### Foreign Investors

A foreign person or entity is not eligible for the cash grant unless the foreign person is doing business in the United States and pays U.S. tax on at least 50% of its gross income from the renewable project. The FAQ clarifies the application of these foreign person eligibility rules in the partnership context. The guidance confirms that a partnership with a disqualified foreign partner is completely ineligible for the grant, regardless of the ownership interest of the disqualified partner.

#### Passive Loss Rules Inapplicable

Another cash grant development benefiting partnerships and private equity funds was not addressed in the FAQs, but has been addressed by Treasury and the Department of Energy in other contexts. This relates to the so-called "passive loss" rules that primarily affect individual investors. Any individual who is an investor in a renewable energy project but is not involved in the day-to-day operations of the project will be subject to the "passive loss" limitations. These limitations require that the ITC and losses attributable to depreciation deductions can be used to offset only *passive income* from the project or similar investments. Most projects will generate net losses in the early years and most individuals do not have other forms of passive income. Wages, salaries and investment income are not considered passive income. As a result, most passive investors can only use the ITC and tax depreciation deductions from a particular project to reduce that project's own passive income. Excess credits and deductions are carried forward to future years until they can be fully absorbed by project income. This could take years, a delay that reduces the present value of the tax benefits compared to using them in the year they are first generated.

Notably, the 30% cash grant in lieu of the ITC is *not* subject to the passive credit limitations. Therefore, an individual investor that would be required to defer and carry forward the ITC and tax losses due to the application of the passive loss rules, can still claim and receive the full 30% cash grant in lieu of the ITC immediately. (Net operating losses attributable to depreciation remain subject to the "passive loss" limitations.) This further liberalization of the cash grant rules should be of interest to funds that are managed for wealthy individuals who would otherwise be subject to the passive loss rules. A fund composed of taxable individual investors would be able to claim a full 30% cash grant for qualifying projects.

#### Commencement of Construction

A third issue that has arisen in the context of the grant program, and on which guidance is hopefully forthcoming, relates to when construction of a project is considered to have begun. Projects must be under construction by December 31, 2010 to qualify for grants under the existing program. Under existing guidance, a developer can demonstrate that construction has commenced by showing either that "physical work of a significant nature" has started, or that the developer has "incurred" more than 5% of the total project cost. Developers of large scale wind and solar projects have struggled with the definition.

Treasury considers each wind turbine, pad and tower to be a separate project, each of which must commence construction by the end of 2010. If the developer pours concrete for the first of a 40-turbine wind farm, has physical work of a significant nature begun on all 40 properties? If a large scale solar project involves off-site manufacture or assembly of components, how much must have occurred before physical work of a significant nature is considered to have begun?

With regard to the 5% test, the use of the word "incurred" has caused concern that the developer must have actually taken delivery of or title to equipment that represents more than 5% of total cost. Spending for preliminary work such as design and engineering work, securing power contracts, permitting and financing does not count. Given the lead time required to order and take delivery of equipment, the 2010 deadline for incurring at least 5% of costs could be difficult for many projects. Treasury is considering clarifying this rule to allow purchase costs to count once the developer "accrues" them -- is under an obligation to

pay them --- rather than when the equipment is delivered. Hopefully these and other questions will be addressed in forthcoming guidance.

#### Legislative Update

Several different bills have been or are expected to be introduced in Congress to amend or extend the cash grant program and other aspects of the stimulus bills that created it. One proposal, introduced as S. 2899, "Renewable Energy Incentive Act," would extend the current program's construction commencement deadline from 2010 to 2012 and would extend the placed in service deadline for all renewables to the end of 2016.

The most recent legislative proposal, introduced as H.R. 4599, "Renewable Energy Expansion Act of 2010," would provide a new refundable tax credit for renewable projects. The proposed credit generally would apply in tandem with the cash grant program, as an alternative subsidy that would be available within the relatively more familiar framework of the existing ITC regime. The eligibility criteria for the proposed credit would be very similar to the cash grant program, although the proposed credit rules differ in certain (mostly favorable) respects. The applicable amounts for the proposed refundable credit are the same the payment amounts under the grant program.

Notably, the construction commencement deadline for the proposed credit is December 31, 2012, (as opposed to December 31, 2010, under the cash grant program). Also, the proposed credit would be available to partnerships and S corporations with tax-exempt investors that would otherwise be completely disqualified from the cash grant program. As noted above, partnerships with tax-exempt partners are not eligible for the grant regardless of the ownership level of the disqualified partner. The proposed credit, however, would be allowed to such partnerships based on the amount of the proportionate ownership interests of the eligible partners.

Although the proposed credit is refundable, it would be subject to offsets for other taxes owed. Any refund payment as a result of claiming the proposed credit would also not be payable within the expedited 60-day period governing the cash grant program, but rather, would be payable sometime after the tax return is filed for the year in which the credit is claimed.