



Expansion of clean energy in the U.S. (tax incentives and cash grants)

KEY PROVISIONS OF THE REVISED AND EXTENDED TAX INCENTIVES AND THE NEW CASH GRANT PROGRAM UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

On July 9, 2009 the U.S. Department of the Treasury released long-awaited guidance on how investors can apply for cash grants in lieu of investment and production tax credits for renewable energy projects. The cash grants program, together with the revised and extended tax incentives for renewable energy, is expected to provide a significant boost to the renewable energy sector in the U.S. and forms a key part of the Obama administration's plans to double renewable energy generation in the U.S. by 2011.

Please note that this briefing only provides general information and not advice on which you can rely to avoid U.S. tax penalties.

Introduction

On February 17, 2009 President Obama signed the American Recovery and Reinvestment Act of 2009 (the Recovery Act) into law. Among the many renewable energy incentives provided in the Recovery Act were revisions and extensions of existing renewable energy tax incentives. Section 1603 of the Recovery Act also created a new program enabling renewable energy projects eligible for production and investment tax credits to receive a government grant equal to the value of these credits (the Section 1603 Grant Program). The private sector has indicated a high level of interest in the Section 1603 Grant Program, which allows renewable energy investors to receive the full benefits of the tax incentives even when they do not otherwise have sufficient tax liability to use tax credits. The U.S. Department of Energy has estimated that the value of the grants provided under the Section 1603 Grant Program will be in the vicinity of \$3bn.

On July 9, 2009 the U.S. Department of the Treasury released long-awaited guidance on how investors can apply for the grants (the Program Guidance). This briefing provides a short overview of the production and investment tax credit programs as revised by the Recovery Act, an analysis of the new Section 1603 Grant Program and a description of how investors can apply for the grants pursuant to the Program Guidance. Readers interested in more information about the program are welcomed to contact our clean energy team.

The Section 1603 Grant Program provides grants of 10-30 per cent of a project's value for certain newly

constructed or recently placed in service renewable energy projects. The Treasury has indicated informally that it will begin to accept applications on August 1, 2009. Applications must be submitted by October 1, 2011. The program is designed to help projects stalled during the economic downturn to recover and to provide a significant boost to the renewables energy industry generally, as part of the Obama administration's overall plan to double renewable energy generation in the U.S. by 2011.

Production tax credits

The Recovery Act extends the availability of a production tax credit (the PTC) for producing electricity from certain wind, biomass, geothermal, solar, small irrigation, hydropower, municipal solid waste and hydrokinetic and marine generation facilities for sale to unrelated parties. The PTC is available for energy produced by a qualified facility placed in service before the end of 2013 (or 2012 for a wind generation facility).¹

The base PTC is 1.5 cents per kilowatt hour as indexed for inflation (2.1 cents for 2009). The credit is available in each of the 10 years from the year when a qualifying facility is placed in service (five years for certain biomass, geothermal, solar and small irrigation power facilities).²

¹ Before the Recovery Act, the PTC was only available for facilities placed in service before 2010 (or 2009 for wind projects).

² The PTC phases out if the reference price for electricity in the previous year exceeds an inflation-indexed threshold (11.8 cents per kilowatt hour in 2008). The phase-out will not apply to electricity sold in 2009.

PTCs from the first four years of production potentially may offset alternative minimum tax (AMT) liability. Excess credits may be carried back one year and carried forward for 20 years.

Investment tax credits

The Recovery Act also significantly expands the investment tax credit (the ITC) for the cost of new energy property. Before the Recovery Act, only certain solar properties, small wind properties and fuel cell properties qualified for a 30 per cent credit and cogeneration facilities and property used to produce, distribute or use energy derived from a geothermal deposit qualified for a 10 per cent credit.

Under the Recovery Act, taxpayers can now elect a 30 per cent ITC for certain PTC-eligible facilities placed in service in 2009 and 2010 (including wind, hydropower, biomass and geothermal and certain solar facilities).³ The ITC is available only for depreciable tangible property that is an integral part of the facility, but the cost basis is no longer reduced by the amounts financed with government subsidized energy financing or private activity bonds. A taxpayer electing to claim the ITC cannot claim the PTC for energy produced by the facility.

In the case of facilities expected to be under construction for two or more years, the credit becomes available as progress expenditures are made (rather than when the property is placed in service). ITCs for tax years beginning after October 3, 2008 can offset AMT liability. Unused credits may be carried back one year or carried forward for 20 years. The taxpayer's basis in property is reduced by one half of the credit claimed.

Renewable energy grants in lieu of tax credits

The Section 1603 Grant Program permits investors in renewable energy projects to claim cash grants instead of credits for facilities eligible for PTCs or ITCs.⁴ The grants provide an incentive for investment in renewable energy projects to investors who have lost the capacity to benefit

from tax credits. The grant is to be 30 per cent of the costs eligible for ITC (10 per cent in the case of properties qualifying for a 10 per cent ITC). Grants are not includable in income and the property's basis is, similar to the ITC, reduced by one half of the grant received.

Eligible taxpayers

Tax-exempt and pass-through entities

Governmental and tax-exempt entities are ineligible for Section 1603 grants, as are partnerships and pass-throughs owned by such entities. However, the Program Guidance clarifies that partnerships and pass-through entities will be eligible as long as government or tax-exempt owners invest through blocker corporations. Tax-exempt institutional investors such as pension funds, as well as partnerships with such investors, can therefore participate if the investment is appropriately structured. Real estate investment trusts (REITs) and subchapter T cooperatives are not considered pass-throughs for this purpose. A foreign person can receive a grant if the foreign person or a U.S. shareholder (under the controlled foreign corporation rules) pays U.S. tax on at least half of the foreign person's gross income from the qualifying property.

Lessees

The Program Guidance allows lessors eligible for a grant to pass their entitlement to lessees who would be eligible for a grant had they incurred the costs directly. Regulated investment companies (RICs), REITs, mutual savings banks and similar financial organizations, however, cannot make this election. The lessee will be treated as having acquired the property for an amount equal to the independently assessed fair market value of the property at lease inception. The lessee must include half of the grant in its income ratably over five years. In a sale-leaseback transaction, the grant belongs to the lessee if:

- the lessee is the original user of the property;
- the lessee leases the property within three months of the date when the lessee placed it in service; and
- the parties do not elect out of the special rules applying to transfer of the grants to lessees.

Eligible properties

To qualify for a grant, the property must be placed in service or its construction must begin in 2009 or 2010.

³ Landfill gas, trash and marine and hydrokinetic facilities also qualify for this election.

⁴ The PTC eligible facilities for which grants may be received are the types for which a taxpayer could elect to claim an ITC.

Construction must be completed before:

- 2013 for large wind projects;
- 2014 for other PTC-eligible property;⁵ and
- 2017 for ITC-eligible property.⁶

The Program Guidance clarifies that construction begins when physical work of a significant nature begins.

An applicant is presumed to have met this standard when it incurs more than 5 per cent of the total cost of the property (excluding cost of land and preliminary activities such as designing and planning). Multiple units of property at the same site that will operate together may be treated as a single unit of property for purposes of determining when construction begins and when the property goes into service.

The applicant must be the original user of the property, but used property can represent up to 20 per cent of the total cost of an otherwise eligible facility. The property must be used predominantly (during at least half of the year) within the U.S.

Recapture

Grants are subject to recapture upon sale of renewable energy properties within the first five years. However, recapture is not required unless the buyer is an ineligible person or an eligible person that does not assume liability for subsequent recapture. The amount recaptured is 20 per cent of the grant for each year remaining in the five-year period. Sellers also will recognize additional gain from a sale of the property because their tax basis in the property will have been reduced by an amount equal to 50 per cent of the grant.

Grantee entitlements

Applicants are not required to post a bond for recapture and grants do not create a government lien on the property. Applicants can assign grant payments to lenders or other third parties, allowing for collateralization. Any funds owed to the Treasury (e.g. from recapture) are considered debts owed to the U.S. government and not tax liabilities.

Grant application process

Consistent with the intent of the Recovery Act, the Section 1603 Grant Program is only available for a short time and the application process has been designed to distribute funds quickly after a project's placed-in-service date.

The Treasury has indicated informally that it will begin accepting applications on August 1, 2009. All applications must be received by October 1, 2011. For property that began construction before 2009 but is placed into service in 2009 or 2010, applications must be submitted after the property has been placed in service. For property for which construction began in 2009 or 2010 that is placed in service thereafter, the application must be submitted after construction commences. Applications submitted before the placed-in-service date must provide supplemental information within 90 days of the placed-in-service date.

The application must document that the project has commenced construction and/or been placed in service as required and that it otherwise qualifies under the program (based on design plans, nameplate capacity and certain technology-specific system requirements). Applicants must also submit a signed terms and conditions document once the qualified property has been placed in service. These terms and conditions include Securities and Exchange Commission-like covenants made under penalty of perjury and further ongoing informational covenants. These covenants survive disposition of the property to third parties.

The Treasury commits to providing payment to qualifying projects within 60 days of the later of the complete application or the project's placed-in-service date.

⁵ Biomass, certain geothermal, landfill gas, trash, certain hydropower, marine and hydrokinetic facilities.

⁶ Solar, certain geothermal, fuel cells, microturbines, cogeneration facilities and small wind facilities.

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