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Treasury Publishes New Q&A as Year-end Deadline Approaches

By Leah S Karlov & Joanna Grossman

The year-end deadline is quickly approaching for new renewable energy projects to start construction to qualify for the federal cash grant in lieu of the 30% investment tax credit. Because renewable energy projects receiving cash grants must reach certain development milestones (including site control, procurement arrangements, locking in funding, and environmental reviews) before breaking ground, a great deal of attention is focused on what it means to start construction for purposes of meeting the year-end deadline. In addition to earlier guidance, on June 24th, 2010, the US Treasury published a series of questions and answers (the "Q&As") clarifying what it means to start construction for purposes of the cash grant.

Background

Section 1603 of the American Recovery and Reinvestment Act of 2009 provides cash grants to owners (and, in some cases, lessees) of solar, wind, and certain other renewable energy projects, the construction of which begins by December 31st, 2010. Construction is treated as having begun when either: 1) physical work of a significant nature has begun; or 2) costs have been paid or incurred that satisfy a 5% safe harbor.

Physical work of a significant nature

Probably the most important news in the Q&As is a warning that "Treasury will closely scrutinize any construction activity that does not involve a continuous program of construction or a contractual obligation to undertake and complete within a reasonable time, a continuous program of construction." Treasury provided this warning in the context of acknowledging that laying the foundation for a single wind turbine generator will satisfy the requirement construction has commenced for a 50-turbine project. The warning is equally applicable to solar and other renewable energy projects. Consequently, project sponsors and investors may be more inclined to rely on the 5% safe harbor to avoid the risk construction delays could preclude cash grant eligibility.

The Q&As provide additional examples of what constitutes physical work of a significant nature while, at the same time, clarifying the boundary between eligible electrical generation equipment and ineligible transmission assets. For example, the Q&As clarify that physical work on a transformer that steps up the voltage of electricity produced at a facility is considered physical work of a significant nature because such equipment is specified energy property. In contrast, work on a transmission tower does not count as physical work of a significant nature because transmission equipment is not specified energy property.

Another example addresses roads built on the construction site. Roads integral to the qualified facility (e.g. onsite roads that move materials to be processed and roads to operate or maintain the facility) are specified energy property. Starting construction on these integral roads will satisfy the commencement of construction standard. However, roads that provide access to the site and roads used solely for employee and visitor vehicles do not constitute specified energy property and, consequently, commencing construction of those roads cannot be counted as beginning construction. Similarly, clearing land or erecting fences does not qualify as physical work of a significant nature; nor does dismantling an existing facility to build a new one.

Work carried out pursuant to a binding contract with a third-party contractor or component vendor may count if the work commences after the contract is entered into. Work performed on inventory of a supplier produced or manufactured before the contract was entered into cannot be counted as physical work of a significant nature. If a binding written contract is entered into with a supplier that produces the same goods for multiple customers, the contractor must be able to demonstrate when the work began with respect to the particular property that will be delivered to the applicant. For this purpose, the supplier may use any reasonable and consistent method to allocate work between customers.

Five percent safe harbor

Under the 5% safe harbor, commencement of construction is deemed to occur when more than five percent of the eligible property costs have been paid or incurred. Without elaboration, the Q&As states that the 5% safe harbor will be satisfied when five percent or more of the total cost of eligible property is paid or incurred. Costs incurred for ineligible property such as perimeter fencing, transmission and interconnection, buildings, employee parking property will not count.

In general, costs are not treated as incurred for purposes of the 5% safe harbor until purchased property or services are delivered or title to the property passes to the applicant (the so-called "economic performance" rules). When relying on the work of a contractor to satisfy the 5% safe harbor, the applicant may treat costs as paid or incurred when costs are paid or incurred by the contractor. Applicants may also include costs paid or incurred by a supplier that is manufacturing property or components for the applicant pursuant to a binding written contract. As with the physical work of a significant nature standard, costs must be incurred after the binding written contract is entered into, and must be reasonably allocated to the specified energy property of the applicant. The ability to treat costs incurred by a supplier as if they were incurred by the applicant only applies to those contracting directly with the applicant. Consequently, costs incurred by a component supplier to a contractor will not be treated as incurred until the components are provided to the contractor (not as the costs are paid or incurred by the supplier). Treasury has also clarified that the cost of components will be treated as having been incurred when title to the components is transferred to the applicant, even though components may be stored at the manufacturer's premises.

Additionally, the Q&As reiterate it is not sufficient to show an applicant reasonably expected costs incurred by December 31st, 2011 to exceed five percent of the project costs. Rather, the costs incurred must be equal to or greater than five percent of the actual total cost of the specified energy property. If a project includes multiple units of specified energy property (e.g., multiple wind turbine generators) and less than five percent of the cost of the eligible property in the entire project has been incurred before year's-end, an applicant can elect to treat the project as including less than all the units of property and apply for a cash grant on that lesser number.

What's next?

At this point, developers and lenders are rushing to get construction of their projects started to meet the December 31st, 2010 deadline. As for alternatives, legislation has been introduced in Congress to provide a refundable 30% tax credit with respect to qualified projects the construction of which commences before January 1st, 2013, and which are placed in service before specified

termination dates. Though, in some respects, the refundable credit would provide greater flexibility than the cash grant program, a significant drawback is the tax refund could be delayed. Instead of being paid within 60 days following submission of a completed application, as is currently the practice with the cash grant, the tax refund would not be paid until some time after the due date of the applicant's tax return for the tax year in which the property is placed in service. At this point, we are assuming that for purposes of applying the commencement of construction requirement of the proposed legislation, the existing guidance and Q&A's would remain applicable.

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