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Treasury Releases Additional Guidance on Beginning of Construction and Posts Checklist and Annual Performance Report on Website

On June 25, 2010, the U.S. Treasury Department ("Treasury") released additional guidance for the Section 1603 Grant Program in the form of frequently-asked questions and answers ("FAQs") with respect to the "beginning of construction" requirement for property placed in service after 2010, and before the applicable sunset date. The FAQs follow the revised program guidance released in March 2010, and described in our prior client alert. A copy of the FAQs is available here. Highlights from the FAQs are summarized below.

Two Ways to Meet Requirement

The FAQs confirm that there are two ways to satisfy the beginning of construction requirement: (1) begin physical work of a significant nature — based on the facts and circumstances; and (2) meet the 5% safe harbor.

Facts and Circumstances Test

Physical Work on the Specified Energy Property. The FAQs confirm that only physical work that is undertaken on the "specified energy property" — i.e., the tangible personal property and "other tangible property" used as an integral part of the activity performed by the qualified facility and located at the site of the qualified facility — is taken into account.

The FAQs draw the same distinction found in the applicable Treasury guidance between roads which are integral to the project, such as roads to access the specified energy equipment, and roads that are not integral to the qualified facility, such as employee access and parking. The FAQs note that fencing generally is not treated as an integral part of the qualified facility, and erecting a fence is not taken into account as physical work.

The FAQs reiterate that preliminary work such as clearing land or obtaining permits is not physical work on the specified energy property. Thus, the removal of existing facilities or demolition work does not count as physical work on the specified energy property, but rather is in the nature of preliminary work. The FAQs also state that the construction of a building at the site that will be used for operations and maintenance is not taken into account as physical work because a "building" is not tangible personal property or other tangible property and, therefore, does not qualify as specified energy property. On the other hand, a structure that is in the nature of equipment, i.e., is so

closely associated with equipment as to constitute "other tangible property," does qualify. The FAQs also reach the same conclusion for property used for electrical transmission. Because such property is not included as part of a qualified facility, it is not considered physical work on specified energy property. Finally, the FAQs state that test drilling for a geothermal deposit is not considered physical work on the specified energy property.

Level of Physical Work Required. The FAQs state that "[i]n general *any* physical work on the specified energy property will be treated as the beginning of construction even if such work relates to only a small part of the facility . . . ." However, Treasury warns that performing some physical work before the end of 2010, followed by a suspension of the work until a much later date, will be "closely scrutinized" unless there is "a continuous program of construction or a contractual obligation to undertake and complete within a reasonable time, a continuous program of construction."

Physical Work under Contract. The FAQs confirm that any physical work performed under a binding written contract may be taken into account, but only to the extent it takes place *after* the binding written contract is entered into. Also, the work is treated as physical work of a significant nature only if it is work on property that will become specified energy property of the applicant. The FAQs explain:

> For example, if a contractor is manufacturing solar panels specifically for the applicant under a binding written contract, any physical work on those panels is physical work of a significant nature on specified energy property of the applicant. If an applicant has a binding written contract with a contractor who is manufacturing solar panels for a number of customers, physical work on the panels would only be considered work performed under the applicant's binding written contract if the contractor can reasonably demonstrate that physical work has started on panels that will become specified energy property of the applicant. The contractor may use any reasonable, consistent method to allocate work it performs among its customers. Whether a method is reasonable depends on all the relevant facts and circumstances.

The FAQs further explain that work performed under a contract does not include work to produce components or parts that are in existing inventory or are normally held in inventory by a manufacturer — i.e., there must be a specific designation of the property to the project in order for the physical work to be taken into account. The FAQs indicate that the specific site or location of the project is not essential for the physical work off-site to be taken into account.

5% Safe Harbor

Section 461(h) Principles. The FAQs confirm that although the revised program guidance deleted specific reference to the "economic performance" principles of section 461(h) of the Internal Revenue Code, those principles continue to apply under the revised program guidance in determining whether costs have been incurred for purposes of the 5% safe harbor. The FAQs explain the deletion and the continued application of the section 461(h) principles:

> A cost is generally "incurred" for tax purposes when 1) the fact of the liability is fixed, 2) the amount of the liability is determinable with reasonable accuracy, and 3) the economic performance test (see Treas. Regs. §1.461-4) has been met with respect to such cost. Although the specific reference to the §461(h) economic performance rules was deleted in the revised Program Guidance, the economic performance rules continue to apply in determining whether costs have been incurred. The 5% safe harbor contained in the Program Guidance includes a single exception to the general principles that are used to determine when amounts are "incurred." Under general rules for property manufactured, constructed, or produced for the applicant by another person under a binding written contract that is entered into prior to the manufacture, construction, or production of the property, the cost of such property is treated as "incurred" when the property is provided to the applicant. The exception is that for periods before the property is provided to the applicant, costs incurred with respect to the property by such other person are treated as costs of the property that are incurred by the applicant

when the costs are incurred by such other person.

Thus, the section 461(h) economic performance rules continue to apply (i) in determining whether the applicant has incurred costs and (ii) in determining whether a person who has contracted with the applicant for the manufacture, construction, or production of property has incurred costs. This is a key clarification.

When Is Property Provided to the Applicant? The FAQs confirm that property is treated as provided to the applicant for purposes of the section 461(h) economic performance rules either when title to the property passes to the applicant or when it is delivered to or accepted by the applicant, depending on the applicant's method of accounting.

Specific Recognition of the 3½ Month Rule. The FAQs specifically recognize that the 3½ month rule under Treas. Reg. § 1.461-4(d)(6)(ii) applies. Thus, property that the applicant (or its contractor) *reasonably expects to be provided* within 3½ months of the date of payment (e.g., December 31, 2010) will be considered to be provided on the payment date (e.g., December 31, 2010). This is another key clarification. Recognition of the 3 ½ month rule allows certain property delivered after December 31, 2010 to satisfy the 5% safe harbor provided that the applicant (or its contractor) pays for the property before December 31, 2010 and the applicant (or its contractor) reasonably expects delivery within 3 ½ months of payment.

Costs Paid or Incurred by Another Person. The FAQs provide the following example to illustrate when costs are paid or incurred by a person providing property to an applicant under a binding written contract:

> Costs are paid or incurred by the person providing property to the applicant as that person pays or incurs costs in connection with providing property to the applicant. For example: In 2010, accrual-method taxpayer W enters a binding written contract to provide a wind turbine to A in June 2012. In 2010, W, pursuant to a contract with Y, pays Y to provide parts in May 2012 for use in the wind turbine. W's employees provide W with services necessary to design and plan for the production of the wind turbine in 2010 and with services to manufacture (assemble) the wind turbine in 2012. W incurs the cost to design and plan for the production of the turbine assembly in 2010, incurs the costs for the parts in May 2012 when Y delivers the parts to W, and incurs the costs for W's employees to assemble the wind turbine in 2012. See § 1.461-4(d)(4), § 1.446-1(c)(1)(ii), and Example 3 of § 1.461-4(d)(7) of the Income Tax Regulations. For purposes of determining whether A has met the 5% safe harbor, A may only include the costs incurred by W to pay its employees to plan and design the turbine in 2010.

The FAQs provide that the applicant may rely on a statement by the supplier as to the amount incurred by the supplier with respect to the property to be manufactured, constructed, or produced for the applicant under the binding written contract. The supplier may use any reasonable, consistent method to allocate the costs incurred by the supplier among the units of property to be manufactured, constructed, or produced by the supplier. However, only costs incurred by the supplier after the binding written contract is entered may be reasonably allocated to the property manufactured, constructed, or produced under that contract.

The FAQs confirm that the economic performance rules apply to determine when costs have been incurred by the supplier. Importantly, the FAQs confirm that the exception for persons under contract with the applicant does not apply when determining when costs are incurred by the supplier. Thus, if components are manufactured for the supplier by a subcontractor, the cost of those components is incurred only when the components are provided to the supplier and not as the subcontractor pays or incurs the costs of manufacturing the components. Accordingly, only the costs paid or incurred by suppliers or contractors that have contracts directly with the applicant are taken into account for purposes of the 5% safe harbor. If work is to be performed by subcontractors or sub-suppliers, applicants may want to consider entering into written binding contracts with such parties in order to include the costs for purposes of the 5% safe harbor.

The FAQs require a reasonable method of allocating costs to specified units of property when the applicant has entered into a binding written contract for multiple units of property.

The FAQs also provide guidance for situations in which a developer assigns its contract rights to a special purpose vehicle that is the applicant for the Treasury Grant. In these circumstances, the FAQs indicate that the costs allocated to property under the manufacturing contract are taken into account to the extent paid or incurred in 2009 or 2010.

5% Safe Harbor Based on Actual Total Costs. The FAQs confirm that "[t]o satisfy the 5% safe harbor applicants must demonstrate that costs paid or incurred before the end of 2010 are equal to or greater than 5% of the actual total costs of the specified energy property." Thus, applicants must be certain that their estimate of total costs builds a sufficient cushion to account for possible cost overruns as Treasury will confirm that 5% of the actual total costs were paid or incurred after the project is placed in service.

Treasury does advise, however, that applicants may choose to disaggregate units of property at a site and apply the 5% safe harbor with respect to only certain units of property. For example, if an applicant incurs $10,000 in costs in 2010 for specified energy property in a 5 turbine wind farm anticipating total costs for specified energy property of $500,000 but the actual total costs of specified energy property amount to $600,000, the safe harbor would not be satisfied. However, the applicant can opt to apply for a payment based on the costs of 3 turbines and would satisfy the safe harbor if the $10,000 of costs incurred in 2010 relates to the 3 turbines and their total cost does not exceed $500,000.

Process

Application(s). The FAQs confirm that for projects placed in service after 2010, but before October 1, 2011, applicants need only submit a single application demonstrating both that construction began on the property in 2009 or 2010 and that property has been placed in service. However, applicants are permitted to submit an application demonstrating that construction has begun and will receive a response. The FAQs state:

> Although we cannot provide assurance that an applicant meets all the requirements for a payment until all facts and circumstances are known (at time the facility is placed in service), we will tell the applicant whether or not the work performed is physical work of a significant nature or, for applicants relying on the safe harbor, whether qualifying costs have been paid or incurred.

Documentation. The FAQs provide additional guidance on the types of documentation required to substantiate physical work and the costs for the 5% safe harbor.

Physical work. In the case of physical work performed by the applicant, applicants should submit a written report from the project engineer or installer, signed under penalties of perjury, describing the project's eligibility; including a detailed construction schedule; estimated budget for the project and a description of the work that has commenced including any invoices for the work performed.

- *Projects with an anticipated cost basis of $1 million or more*: The report must be from an independent engineer.

To demonstrate that physical work of a significant nature has commenced under a binding written contract, applicants should submit a copy of the binding written contract and a statement from the contractor, signed under penalties of perjury, describing the work that has commenced and certifying that the work commenced pursuant to the binding written contract.

5% Safe Harbor. For projects relying on the 5% safe harbor, applicants must submit a statement (described below) from an authorized representative of the applicant signed under penalties of perjury.

- *Projects with an estimated eligible cost basis of $1 million or more*: The statement must be from an independent accountant.

The documentation submitted differs depending on whether the applicant uses the cash-method or accrual-method of accounting:

- For applicants that use the cash method of accounting, the statement should state the amount that has been paid before the end of 2010; a detailed description of the costs that have been paid; and an estimate of the total cost of the specified energy property and must include evidence of payment such as invoices or other financial records.
- For applicants that use the accrual method of accounting, the statement should state the

amount that has been incurred before the end of 2010; a detailed description of the costs incurred; and an estimate of the total cost of the specified energy property and must include evidence of the costs incurred such as invoices or other financial records.

If an applicant is relying on costs paid or incurred by a contractor, a copy of the binding written contract and a statement from the contractor, signed under penalty of perjury, of costs paid or incurred and allocated to applicant's project must be included. The FAQs note that "[a]dditional documentation may also be required depending on the facts and circumstances. If additional documentation is required applicants will be notified."

Checklist Posted

In addition to the FAQs, Treasury recently posted a checklist for applications submitted under the Treasury Grant program on the Section 1603 website. A copy of the checklist is attached. Generally, the checklist provides additional information regarding documentation that is required to be submitted, examples of documentation that is not sufficient, and certain new information that was not mentioned in prior Treasury Grant program guidance. Reviewing and complying with the checklist should help reduce the regular Treasury requests for additional information from applicants and assist in expediting payment. For example:

- If an applicant has a business website, the website address should be provided in the application.
- If the applicant is a limited liability company (LLC) which is not taxable as a corporation, the applicant should provide an organization chart and/or narrative which clearly explains the ownership of the LLC and demonstrates its eligibility as a taxpaying entity.
- The signed and dated commissioning report confirming that a project is placed in service must be completed by the installer or engineer of the project; a local agency inspection will not be accepted by Treasury as a commissioning report.

Annual Performance Report Posted.

Treasury also posted on the Section 1603 website that all applicants receiving awards under the Treasury Grant program are required to report — consistent with the Terms and Conditions applicants are required to submit to Treasury with their applications — certain information annually to Treasury for a period of five years. Treasury states that reports are due annually, 30 days after the anniversary date of the date the property was placed in service. The form used to submit this report is now available on-line and can be completed and submitted through the on-line application system. Treasury states that applicants will receive a reminder notification via email 30 days before the report is due.