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# Client Alert

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## BEGINNING OF CONSTRUCTION FOR PURPOSES OF SECTION 1603 CASH GRANTS

Section 1603 of the American Recovery and Reinvestment Act of 2009 directs the United States Treasury to pay cash grants (“Grants”) to owners (and, in some cases, lessees) of certain renewable energy property the construction of which begins in 2009 or 2010 and which is completed before specified outside dates. In July, 2009 Treasury published “Program Guidance” describing what property is eligible for Grants and the procedures to apply for a Grant (a copy of which can be found by clicking [here](#)). Treasury recently revised that Guidance in an attempt to clarify when construction of eligible property will be viewed as having commenced. This memorandum summarizes the “Beginning of Construction” rules as published by Treasury.

In general, construction begins when “physical work of a significant nature” begins or, pursuant to what is described in the Program Guidance as a “safe harbor”, when 5% of the total cost of the project has been paid or incurred in accordance with the principles described below.

### I. Physical Work of a Significant Nature

Physical work of a significant nature encompasses both work carried out by the grant applicant itself and work carried out for the applicant under a binding written contract. Moreover, both work carried out on-site and work carried out off-site will be taken into account in order to determine when physical work of a significant nature has begun.

Physical work of a significant nature includes on-site construction activities such as digging foundations and pouring concrete equipment footings as well as off-site activities such as the manufacture of components for on-site delivery and assembly.<sup>1</sup> Preliminary activities such as planning or designing, securing financing, clearing a site, test drilling of a geothermal deposit and excavation to change the contour of land (as opposed to excavation for footings and foundation) will not qualify as physical work of a significant nature.

<sup>1</sup> The Program Guidance refers to the example of a wind facility to further explain this standard, providing that on-site work of a physical nature may begin with excavation for the foundation of the facility, setting anchor bolts into the ground, or pouring concrete pads for the foundation. Where a wind facility’s turbines and tower units are assembled on-site from components manufactured off-site, physical work of a significant nature may begin when manufacture of the components begins off-site.

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Where the applicant seeks to rely on physical work carried out by a third party in manufacturing, constructing or producing eligible property (or components), on its behalf, the work performed must be performed pursuant to a binding written contract entered into before the property (or components) have been manufactured, constructed or produced. To be considered binding, the written contract must be enforceable under state law against the applicant or predecessor, and the contract cannot limit damages to a specified amount that is less than 5% of the total contract price. A contract is not considered binding for this purpose if it provides a full refund of the purchase price in lieu of damages in the event of breach or cancellation. A contract continues to be binding if the parties make insubstantial changes to its terms and conditions (e.g. minor modifications to design specifications such as a cold weather package for wind turbines), or if terms are determinable in the future by a standard beyond the control of the contracting parties. Options will not qualify as binding contracts nor will supply or other agreements that fail to specify the amount or design specifications of the property to be purchased.

## II. 5% Safe Harbor

Treasury's Program Guidance provides that construction of eligible property will be treated as having begun when more than 5% of the total cost of the property has been paid or incurred.<sup>2</sup> Except as noted below, Treasury has also indicated that costs may be treated as paid or incurred only when "economic performance" under the principles of section 461(h) of Internal Revenue Code (the "Code") has occurred.<sup>3</sup>

For purposes of Code section 461(h), "economic performance" occurs when property is delivered or accepted, title to property passes, or when services are rendered to the taxpayer. Alternatively, "economic performance" occurs at the time of payment for goods or services if the taxpayer reasonably expects those goods or services to be provided within 31/2 months of the date of payment.<sup>4</sup>

For applicants who construct their own property, these standards are applied to the costs paid or incurred by the applicant. But, where property (including a component of the property) is being manufactured, constructed or produced by a third party for the applicant under a binding written contract (as discussed above) entered into before the property (or component) has been manufactured, constructed or produced, Treasury's Program Guidance relaxes the Code section 461(h) "economic performance" rules described above. In that case, the applicant can treat as costs paid or incurred by it the costs paid or incurred by the third party (applying the Code section 461(h) economic performance rules described above) in manufacturing, constructing or producing the property (or component).<sup>5</sup>

Costs paid or incurred for engineering or design work and other preparatory activities count towards the 5% safe harbor threshold to the extent those costs will be capitalized as part of the cost of the facility for federal income tax purposes.

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<sup>2</sup> Note that the threshold amount is 5% of the actual total costs of the eligible facility, not the projected total cost of the facility.

<sup>3</sup> The original Program Guidance, published in July 2009, explicitly invoked the application of the economic performance standards of Code section 461(h). Although the express reference to the principles of Code section 461(h) was removed from the revised Program Guidance, Treasury officials have publicly explained that they did not intend to eliminate the concept from the revised Program Guidance, and they intend to apply the principles of Code section 461(h) to the evaluation of Grant applications for property placed in service after December 31, 2010.

<sup>4</sup> To ensure Grant eligibility on the basis of goods or services to be provided within 31/2 months of the payment date, the underlying contract should specifically identify payment with the goods and/or services to be provided. For example, long-term EPC contracts should be structured to require progress payments for specified work to be done during the initial 31/2 month period (rather than undifferentiated payments).

<sup>5</sup> Note that because the Program Guidance refers to the actual costs of the third party, the applicant cannot include as a cost paid or incurred by it any profit margin on the services or property being provided by the third party.

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### III. Course of Action for Taxpayers Seeking Grant Eligibility

To ensure Cash Grant eligibility for projects that will be placed in service after year's end, you should, before December 31, 2010:

1. Perform on-site physical construction of a significant nature (beyond clearing and grading, as discussed above);
2. Enter into a binding written contract to purchase a major component that the supplier will, during the fabrication period, be able to identify with your contract and require that the supplier actually perform fabrication of a significant nature with respect to that component;
3. Pay or incur more than 5% of the total project cost in accordance with the general "economic performance" principles described above; or
4. Pay more than 5% of the total project cost pursuant to a binding written contract that requires delivery of the corresponding goods or the performance of the corresponding services (e.g., fabrication of a component) within 31/2 months of the payment date (counting only actual amounts spent, not the profit component towards the 5%).

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