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Client Alert

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UPDATE ON ARRA RENEWABLE ENERGY GRANTS

Last week at a Milbank sponsored energy conference, a senior official from the United States Treasury Department (the “Treasury”) provided additional information about the cash grant program for ITC eligible renewable energy projects established by the American Recovery and Reinvestment Act (“ARRA”). This Client Alert describes additional information learned about the expected procedures, timing, and administration of the grant program and supplements Milbank’s April 3, 2009 Client Alert describing ARRA’s incentives for renewable energy.

Background

ARRA requires Treasury to provide cash grants to applicants who place in service renewable energy facilities that would otherwise qualify for the investment tax credit (the “ITC”) (including those production tax credit eligible facilities for which taxpayers are able to elect and claim the ITC under ARRA).

In general, the grant amount is equal to the amount of allowable ITC, i.e., 30 percent of the basis of qualifying property. For qualified microturbines, combined heat and power system property, and geothermal heat pump property, the amount is 10 percent of the basis of the property. To be eligible, the facility must (1) be placed in service in 2009 or 2010, or (2) construction of the facility must begin in 2009 or 2010 and the facility must be placed in service before specified dates (before January 1, 2013 in the case of wind facilities, January 1, 2014 in the case of facilities generating electricity using closed or open-loop biomass, geothermal, landfill gas, municipal solid waste, hydro and marine and hydrokinetic renewable energy resources and January 1, 2017 in the case of solar energy property, qualified fuel cell property and other property eligible for ITCs under pre-ARRA law).

Procedure

Grant applicants will be required to submit a form establishing their eligibility and qualification for the program. Individuals from Treasury and the Department of Energy are continuing to negotiate the contents of this form, which is no longer expected to be a short, single page form. Instead, the form will likely take the form of a worksheet, and may be thirty pages or longer in length, with additional attachments required. The form will include instructions on how to fill it out, a description of the program, and a set of “terms and conditions.” Among other things, grant applicants will be required to agree to return the unvested portion of the grant if the project is disposed of within five years.

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Treasury will accept applications before a property is placed in service, though the grant will not be paid until after the property is placed in service. Because Treasury realizes that taxpayers may not have final cost numbers at the time they apply for a grant or at the time the grant is paid, the current draft form of application requires grant recipients to agree to return funds if the recipient is initially overpaid. The current draft form of application does not provide a mechanism for grant recipients to receive additional funds if final costs figures are higher than initially reported.

As statutorily required, grants will be paid sixty days after the later of the date the property is placed in service or the date Treasury receives an application for a qualified project. Because of limited staffing at Treasury, applications will likely be reviewed by individuals at the Department of Energy rather than the IRS. In some cases, Department of Energy, Treasury and/or IRS personnel may contact applicants to confirm eligibility. Payment of grants may be delayed while responses to these inquiries are processed. These inquiries are expected to occur within the sixty day application review window. Qualified applicants will be paid via electronic fund transfers. Treasury expects to process between 3,000 and 5,000 applications.

Timing

Guidance, instructions and the application form for the grant program have been delayed. Treasury may not release its initial guidance by the previously announced June 30th deadline, but still expects to release its initial guidance, the application form and its related instructions some time in July. Moreover, several issues will not be addressed in the initial July guidance. Supplemental guidance is anticipated at a later date.

Substantive Legal Issues

In preparing the form and its instructions, Treasury has confronted many substantive legal issues that surround the implementation of the renewable energy grant program. In particular, Treasury has encountered complexities when drawing analogies from the tax treatment of the investment tax credit to the cash grant context. While Treasury has not formally announced its official views on the appropriate tax treatment of the grant, the Treasury official indicated the following:

- ***Partnership Recapture Upon a Sale or Disposition.*** If the grant is awarded to a partnership, a sale by a partner will not trigger recapture so long as the sale is sufficiently small that the partnership will not terminate for tax purposes. Generally, a partnership terminates for federal income tax purposes if there is a sale or exchange of fifty percent or more of the total interests in the partnership's capital and profits within a twelve month period. The determination of whether there has been a sale or exchange of partnership capital and profits is highly technical; for example, a transfer to an affiliate for no consideration may be treated as a sale or exchange and a transfer of interests in an upper tier partnership is treated as a sale or exchange of the upper tier partnership's interest in the lower tier partnership if, but only if, the transfer of interests in the upper tier partnership causes the upper tier partnership to terminate for tax purposes. In that case the upper tier partnership is treated as having sold or exchanged its entire interest in the lower tier partnership. We expect senior lenders will be focused on controlling transfers at the partnership and upper tier levels to mitigate the risk of a technical termination. Such controls could be effected through covenants in credit documents and partnership agreements, and potentially even independent member/director consent rights to transfers. Lenders will also be analyzing the impact on the potential for a technical termination of a partnership in the case of foreclosure on less than all of the interests in a partnership — especially in a disproportionate allocation partnership where the economic interests of the parties may not be easily quantifiable into clear percentage interests.
- ***Partnership Recapture Liability.*** Partnership recapture liability will rest with the partnership and not the individual partners. This will mean that structural subordination of the recapture claim by having a partner claim the grant will not be successful. It will also mean that senior lenders will be more concerned with controlling the circumstances in which a recapture claim can arise. As noted above, we expect that senior lenders will require contractual provisions to prevent transfers of interests at the partnership level and upper tier levels. Lenders may also seek indemnities from sponsors as to any claims arising from a recapture claim.

- ***Non-Tax Claim Status of Recapture Liability.*** Recapture liability will be treated as a non-tax claim. As a consequence, the government's claim will be an unsecured creditor's claim and will not present the potential conflict on future revenues with a senior secured claim as would a tax lien. However, as a condition to an applicant's receipt of the grant, the government may require a subordinated lien on a project, in which event the terms of subordination will be subject to approval of the project's senior lenders (though the government may not permit much negotiation as to the terms of the subordination).
- ***Tax-Exempt Investors Do Not Qualify.*** Grant applicants with certain tax-exempt investors will not receive a grant. Treasury will strictly enforce this explicit statutory rule. Any corporate "blocker" between the grant recipient entity and a tax-exempt entity equity holder must be in place before the grant is paid and possibly before the project is placed in service. Tax-exempt entities include charitable organizations, federal, state and local government instrumentalities and agencies, and qualified issuers of clean energy renewable bonds (but, notably, does not include non-governmental pension plans).
- ***Mobile Equipment Subject to Recapture.*** Equipment used outside the United States will be subject to recapture rules. Applicants with mobile equipment will be required to keep records of where the mobile equipment is used.
- ***Passive Loss and At-Risk Restrictions.*** Passive loss and at-risk restrictions associated with the ITC will not apply to renewable energy cash grants.
- ***Electricity Sales to Third Parties.*** Projects that would be required to sell electricity to third-parties to qualify for production tax credits will not be required to make third-party sales for the purposes of grant program eligibility.
- ***No Private Letter Rulings.*** The IRS will not issue any private letter rulings about the program.
- ***Accounting.*** To be grant eligible, regulated utilities must use a normalized method of accounting.

Additional Issues Under Consideration

For projects placed in service after 2010, Treasury is still considering how to define when construction of a project has begun for purposes of grant eligibility. Similarly, in response to comments from wind energy industry representatives, Treasury is hoping to accommodate a request that a wind farm be deemed to have a single start date for purposes of determining when a grant is earned and payable (as opposed to the historical view of the IRS that each wind turbine has a separate placed-in-service date).

While Treasury does not believe that provisions of Division A of ARRA pertaining to the applicability of the Davis-Bacon Act "prevailing wage" requirement and National Environmental Policy Act review apply to the grant program, an environmental group has sued the IRS insisting that they do. This suit will be resolved in the federal courts.

Reportedly, several issues associated with the ability to pass-through the grant to lessees have not been resolved, and will not likely be resolved before Treasury's initial official guidance is issued in July.

As a final word of caution, be advised that Treasury has not yet issued any official guidance on the renewable energy grant program. The foregoing description reflects public comments by a senior Treasury official only. The official position of Treasury may change from the foregoing.

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