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Tax Group Client Alert

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TREASURY ADDRESSES 5% SAFE HARBOR OWNERSHIP REQUIREMENTS FOR THE SECTION 1603 CASH GRANT AS YEAR-END APPROACHES

On Monday, December 12, 2011, Treasury published two new questions and answers (the "Q&As") addressing when transferees and purchasers of renewable energy property and entities owning such property will qualify for the so-called "5% commencement of construction safe harbor".

To be eligible for the cash grant provided by Section 1603 of the American Recovery and Reinvestment Tax of 2009 (the "Cash Grant"), the construction of a project must begin by December 31, 2011. This "commencement of construction" requirement will be satisfied if, by December 31, 2011, either (1) physical work of a significant nature has begun on the project or (2) more than 5% of the total cost of the eligible property is paid or incurred (the "5% safe harbor").

As the year-end deadline quickly approaches, questions have been raised as to how to apply the 5% safe harbor to (1) a transferee of energy property and (2) the purchaser of an entity that has met the 5% safe harbor, where the transfer or purchase occurs after year's end. We discuss below the answers to these questions as provided by the Q&As.

Our previous Client Alerts on the Cash Grant can be found on our website (July 2009, March 2010, June 2010 and December 2010). The Q&As are attached below and additional information regarding the Cash Grant can be viewed here.

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Changes in Ownership of Energy Property (Q&A 23)

Q&A 23 addresses what happens if the ownership of energy property changes (whether by contribution, assignment or other transfer) between the time the property is acquired for use in a project and the time the project is placed in service (e.g., a parent entity acquires property for use in a project and subsequently contributes the property to an existing or newly formed subsidiary before the property is placed in service.) Q&A 23 provides that, for purposes of the 5% safe harbor, the transferee of property will be treated as having paid or incurred the cost of the property at the time such costs were paid or incurred by the transferor if (1) the property was acquired by the transferor for use in the same project for which the transferee will use the property and (2) the transferee and transferor are related. A transferee and transferor will be treated as related if they are related persons within the meaning of Section 197(f)(9)(C) of the Internal Revenue Code either immediately before or after the contribution, assignment or transfer. Under this rule, a partner is related to a partnership if the partner owns, directly or indirectly, more than 20% of the capital or profits interests in the partnership, and two partnerships are related if the same person owns, directly or indirectly, more than 20% of the capital or profits interests of each partnership. Similarly, a corporation and a partnership are related if the same person owns more than 50% (by value) of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership, and an individual and a corporation are related if the individual owns, either directly or indirectly, more than 50% (by value) of the stock of the corporation.

Q&A 23 also provides that except in the case of sale and leaseback arrangements that satisfy certain requirements, if energy property is sold to an unrelated purchaser after December 31, 2011, the purchaser of that property may not include the costs incurred by the transferor for purposes of determining whether the 5% safe harbor is met. As with past Treasury Guidance, the Q&As fail to provide a coherent distinction between the purchase of assets and the interests in an entity that is "disregarded" for federal income tax purposes.

Changes of Ownership of Entities Owning Energy Property (Q&A 24)

Q&A 24 addresses what happens if ownership of an entity that met the 5% safe harbor changes before the property is placed in service. If ownership of an entity changes after December 31, 2011, but before property owned by the entity is placed in service, the entity's eligibility under the 5% safe harbor will not be affected if (1) the purchaser is otherwise an eligible cash grant applicant and (2) the acquired entity had commenced development of "a project". Development of a project is evidenced by activities such as acquiring land, obtaining permits, contracting with an engineering, procurement and construction contractor and entering into power sales and interconnection agreements. Q&A 24 further clarifies that if the entity previously satisfied the 5% safe harbor by purchasing and taking delivery of equipment but had undertaken no development activities, the purchaser of the entity may not rely on the costs previously incurred by the entity to satisfy the 5% safe harbor. In other words, the 5% safe harbor will not be satisfied if a person purchases eligible property by December 31, 2011, contributes the property to an entity and then sells the entity, without undertaking any development activity beyond the equipment purchase.

The Q&As generally reflect what practitioners and Cash Grant applicants understood to be Treasury's position based on informal correspondence and conversations with Treasury. However, as newly articulated by Treasury in Q&A 24, particular consideration should be given to the fact that the purchaser of an entity that holds eligible energy property but has not undertaken other development activity, will not be entitled to count the costs paid or incurred by the entity in purchasing that property for purposes of the 5% safe harbor.

Excerpt

Payments for Specified Energy Property in Lieu of Tax Credits
Under the American Recovery and Reinvestment Act of 2009

FREQUENTLY ASKED QUESTIONS AND ANSWERS
"BEGINNING OF CONSTRUCTION"

Q23. For applicants relying on the 5% safe harbor, what happens if ownership of the energy property changes between the time the property is acquired for use in a project and the time the project is placed in service?

A23. If a person (the transferor) contributes, assigns or transfers property to a second person (the transferee) and the transferee uses the property in a project, the transferee is treated for purposes of the 5% safe harbor as having paid or incurred, at the same time as the transferor, the costs that the transferor paid or incurred to acquire the property, but only if the transferor acquired the property for use in that project and is related to the transferee. A transferee and transferor that are related persons within the meaning of section 197(f)(9)(C) of the Internal Revenue Code immediately before or immediately after the contribution, assignment, or transfer of the property will be considered related for this purpose. However, if property is sold to an unrelated purchaser after December 31, 2011, the purchaser may not take the costs that the transferor incurred with respect to the property into account in determining whether the 5% safe harbor is met. This limitation does not apply in the case of a sale/leaseback arrangement. If an entity which met the 5% safe harbor with respect to a facility sells the facility to an unrelated entity and leases the facility back from that entity within 90 days of the placed in service date, the purchaser of the facility (assuming all other eligibility requirements are met) would be treated as satisfying the 5% safe harbor.

Q24. For applicants relying on the 5% safe harbor, what happens if ownership of the entity that met the 5% safe harbor changes before the property is placed in service?

A.24. If ownership of the entity that met the 5% safe harbor changes after December 31, 2011, and before the property is placed in service, eligibility is not affected if (1) the purchaser is an otherwise eligible Section 1603 applicant and (2) the entity being sold had commenced development of a project as evidenced by activity such as acquiring land, obtaining permits and licenses, entering into a power purchase agreement, entering into an interconnection agreement, and contracting with an Engineering, Procurement and Construction contractor. The purchaser of an entity which holds equipment only may not rely on costs paid or incurred to acquire that equipment. For example, a project company meets the safe harbor and commences development of a project by acquiring permits, a power purchase agreement and an interconnection agreement. A partnership interest in the project company is sold to a tax equity investor (or the tax equity investor makes a capital contribution in exchange for a partnership interest) in a partnership flip transaction. The project company (with the tax equity investor as a partner) may rely on costs incurred by the project company to satisfy the 5% safe harbor. On the other hand, if a project company meets the safe harbor by purchasing and taking delivery of equipment but does no other activity, the purchaser of the project company may not rely on costs incurred by the project company to satisfy the 5% safe harbor.

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