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The Renewable Energy Grant under the American Recovery and Reinvestment Act

Tax issues and anomalies

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One of the most important incentives for renewable energy provided in the American Recovery and Reinvestment Act of 2009 (the "Act") is the renewable energy grant. The grant permits owners of facilities that would otherwise be eligible for an investment tax credit ("ITC") to receive a cash grant instead. Property eligible for the grant includes the qualifying portion of certain facilities that were, and continue to be, eligible for the production tax credit ("PTC")—wind, closed and open biomass, geothermal, landfill gas, trash, hydropower and marine, and hydrokinetic facilities. Below discusses a few surprises in the Act, some potential and unexpected limits on the availability of the grant, and the guidance needed to deal with the grant, including the possibility of recapture in the context of partnerships.

Eligibility: Tax exempt partners

A partnership is not eligible for the grant if any partner is a government agency, or instrumentality, a tax-exempt entity described in section 501(c) of the Internal Revenue Code (the "Code"), or a tax exempt electric cooperative. This provision appears to be superfluous, over- and under-inclusive, and draconian. It is superfluous in that Treasury is also directed to apply rules similar to the rules in Code section 50, which already cover partnerships that include tax exempt entities. Sensibly, the Code section 50 rules do not prevent taxable partners in a partnership from receiving the credit if the tax exempt partners are subject to unrelated business income tax on their share of the partnership income (as they usually would be). The grant provision is over-inclusive because it does not have that exception. It is under-inclusive in that it defines tax-exempt entities narrowly, covering only governments and charities so, notably, it does not cover pension plans (or at least non-governmental pension plans) that are also exempt from US income tax, but are not described in section 501(c). (Non-governmental pension plans may be picked up by the reference to Code section 50, but are not likely a problem because the partnership income is subject to the unrelated business income tax.) Finally, the limitation is draconian because a 1% tax exempt partner can cost a partnership 100% of the grant.

Given this limitation on the availability of the grant, it is important any partnership taking the grant not have any prohibited partners, and that it limit transfers of interests to prohibited partners. The difficulty with such prohibitions is policing indirect transfers. A number of funds are currently being planned that would invest in alternative energy and a number of individuals are interested in investing in those funds for commercial and green reasons. One can envision a scenario where a family limited partnership invests in a fund that invests in alternative energy. Should the entire credit be forfeited if some holder of an interest in the family limited partnership gives that interest to her favorite charity?

Obviously, Treasury cannot resolve this statutory problem completely. However, it should have the authority to provide some kind of de *minimis* rule. For example, in the case of an upper tier partnership that was a passive investor, Treasury could permit ignoring interests held by tax exempt investors as long as no tax exempt investor held more than 10% of the upper tier partnership, and all indirect tax exempt investors in such passive entities held no more than a 10% aggregate interest in the facility.

Other concerns and observations

The Act includes a number of surprises that might not have been anticipated. On the positive side, it allows a full 30% ITC and cash grant to owners of a number of types of renewable energy facilities for which the allowable PTC was, and continues, to be subject to a 50% reduction. Consequently, owners of these facilities, which include electric generating facilities fueled by open-loop biomass, landfill gas, and municipal solid waste, are provided a substantially greater benefit by the Act than under prior law. Also, owners of geothermal facilities that had previously qualified for only a 10% ITC are now eligible for a 30% ITC or cash grant.

Left to be answered by Treasury is the treatment of electric generating facilities that co-fire with a fuel other than a "qualified energy resource." Under the PTC regime, facilities that burn biomass (closed- or open-loop), landfill gas, or municipal solid waste and another non-qualified fuel can, in many circumstances, claim PTCs on the portion of the electricity attributable to the qualified energy resource (usually allocated on the basis of relative Btu content of the different fuels). These facilities are "qualified facilities" within the meaning of section 45 of the Code and, on a plain reading of the Act, would appear eligible for a full 30% ITC or cash grant. Although Treasury officials have informally indicated they do not intend to impose additional eligibility limitations on these facilities, the rules or regulations implementing the ITC and grant provisions of the Act may adopt some minimum qualified fuel requirements, both for initial eligibility and to avoid ITC recapture or an obligation to repay grants.

The Act provides cash grants for qualified facilities placed in service after 2010 only if construction began by the end of calendar year 2010. Many have asked (and it is unclear) what standard Treasury will use to determine when construction has begun. Moreover, Treasury has adopted inconsistent standards in the past for interpreting different similarly worded provisions of law. For instance, will having made significant contractual commitments to build or buy components qualify if physical construction has not yet begun? Will drilling wells for geothermal projects without more constitute beginning construction? Hopefully, Treasury will provide guidance in this area.

As noted earlier, the Act directs the Treasury Department to "apply rules similar to the rules of section 50" of the Code for purposes of the cash grants. It is unclear from this short directive how much of and how literally Congress intended section 50 to be applied. Clearly, Congress intended to incorporate grant repayment rules similar to the staggered vesting ITC recapture provisions contained in section 50(a), and we have all assumed the reference to section 50 was intended to include the special rules provided for sale-leasebacks. Those special rules: 1) afford lessors a three-month window following the date a facility was first placed in service to purchase the facility and still be treated as the original owner entitled to the grant; 2) permit a lessor to elect to pass the grant through to its lessee.

But section 50 contains a number of other rules that, if applied, would not be helpful to the industry. It denies ITC to "public utility property" (which includes most electric generating property owned by public utilities) if the utility's cost of service for ratemaking purposes is reduced by reason of the ITC, or the base to which the utility's rate of return for ratemaking purposes is applied is reduced by the ITC. This warrants a note of caution for any project owned by a public utility, or in which a public utility is a partner. Many utilities will say it is not a problem as their public utility commissions have already agreed that ITCs do not reduce their rate base or cost of service for ratemaking purposes. But, if they adopt this aspect of section 50, Treasury may say that grants are denied if the grant will reduce the utility's cost of service or base for ratemaking purposes. The specific rules public utility commissions have adopted in the past to deal with ITC may not be broad enough to deal with this new cash grant and, considering the speed with which many state commissions act, projects coming online in the near future that are owned in whole or in part by public utilities might find themselves ineligible for all or a portion of the grant.

One final feature of section 50 worth noting is that although PTCs are generally available for property located in US possessions without regard to the citizenship of the owner, section 50 limits eligibility for the ITC (and, by implication, the renewable energy grant) to US citizens, domestic corporations, and partnerships—all of the partners in which are US citizens or domestic corporations.

Partnership accounting

If a single investor owns a $100 million facility, the tax consequences of receiving a $30 million grant are clear. The grant is not included in income and the investor must reduce the basis of the facility by half the grant, $15 million to $85 million. If investors own the property through a partnership, corresponding adjustments must be made to the investors' basis in their partnership interests, and to their capital accounts (i.e. basis and capital accounts must be increased by the amount of the grant—$30 million—and decreased by the basis adjustment—$15 million). These adjustments preserve the relationship of the capital account balances of the investors to the partnership's capital and, given the rule that partners cannot take deductions in excess of the basis of their partnership interests, allow the partners the full benefit of $85 million of depreciation deductions by the partnership. But, in partnerships with flips, it is unclear how the increases in partnership basis and capital account balances are to be shared by the partners and, if the grant is distributed to the partners, whether these increases and decreases must correspond to the cash distributions.

There are two ways of approaching the issue. One can view the grant as representing tax-exempt income of the kind referred to in Code section 705(a)(1)(B). If so, the tax-exempt income can be allocated to the partners in any fashion that satisfies the Code section 704(b) regulations. The basis decreases should then probably, but not necessarily, be allocated in the same fashion. Cash distributions would have their own significance and can be made in any manner as long as the capital accounts of investors receiving the distributions are reduced. This provides for maximum flexibility and, therefore, increases the likelihood the grant will encourage investment in alternative energy.

A second approach would treat the grant more like the ITC

that would have been available to the investors. Treasury could treat each partner as if it had received the portion of the grant equal to the ITC it would have been allocated, and then as having contributed those funds to the partnership. The deemed contribution and the required basis reduction for half the grant would maintain the parity between capital account balances and inside (asset) and outside (partnership interest) tax basis. If the cash were then distributed to partners in proportions other than the deemed contributions, under appropriate circumstances, the disguised sale rules of Code section 707 would apply and a partner contributing property and receiving a disproportionate cash distribution might be viewed as selling a portion of the property to the partnership. Of the two approaches, maximum flexibility would be preferable for investors. However, more importantly than which approach is followed is having Treasury choose an approach and make its consequences clear.

Recapture

Provision requires Treasury to provide recapture rules for the grant. How are those rules to be applied if the grant is given to a partnership? As a frame of reference, under the current ITC rules, partners claim the ITC on their tax returns. If a partner sells its partnership interest, or has that interest reduced by more than a third during the five year period before the ITC is fully vested, the partner suffers recapture and reports the recapture on its tax return. The partnership and other partners are not involved in the recapture.

The approach Treasury takes to the question of how to recapture the grant may depend on the approach taken to the partnership accounting rules discussed above. If a partnership has maximum flexibility in how it allocates basis and distributes cash, then it is critical the item to which recapture is tied is made clear. Though it might make intuitive sense to relate recapture to the way the grant was distributed, the grant need not be distributed and cash is fungible. Probably recapture should be tied to increases in capital account balances and basis related to the deemed allocation of tax-exempt income. If the grant is deemed as received by a partner and then contributed by the partner to the partnership, then there is a natural way of applying the recapture rules.

When the recapture rules are applied, there is a large practical issue. The partnership itself received the grant. It is unlikely, though it would solve many problems, that Treasury would be willing to pursue each partner separately for the grant recapture. If the partnership must pay the recapture, then it and all the partners are at the mercy of any partner who transfers its interest. Partnership agreements will have to be amended to deal with that issue, by prohibiting transfers that would cause recapture, limiting the ability of lenders to foreclose on pledges of partnership interests (if those pledges are permitted at all) and providing for indemnities. None of these are total solutions, especially in the now prevalent bankruptcy context. These practical issues make Treasury clarification of the recapture rules critical.

The foregoing summarizes just a few of the unresolved issues under the Treasury grant program—and shows how a “simple” statute can run afoul of existing regulatory complexity. In informal conversations, Treasury officials have indicated they hope to publish guidance on the new grant rules by June 30th and forms of grant applications by the end of July. Until then, we advise caution in making assumptions as to how these issues will be resolved.

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