Hunton & Williams

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Contacts

Laura Ellen Jones
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8746
ljones@hunton.com

David S. Lowman, Jr.
1900 K Street, NW
Washington, DC 20006-1109
(202) 419-2070
(804) 788-8789
dlowman@hunton.com

Leslie A. Okinaka
200 Park Avenue
New York, New York 10166-0091
(212) 309-1276
lokinaka@hunton.com

B. Cary Tolley, III
1111 Brickell Avenue
Suite 2500
Miami, Florida 33131
(305) 810-2533
(212) 309-1180
ctolley@hunton.com

David Weisblat
1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1980
dweisblat@hunton.com

Timothy L. Jacobs
1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1669
(804) 788-8362
tjacobs@hunton.com

Planning Opportunity: Treasury Grant Guidance Permits Leasing to Governments and Tax-Exempts

The Treasury Department recently released "Frequently Asked Questions and Answers," providing supplemental guidance under section 1603 of the American Recovery and Reinvestment Act of 2009, i.e., the Treasury Grant program for specified energy property (the "Supplemental Guidance"). The Supplemental Guidance provides a significant planning opportunity with respect to energy transactions involving governmental entities and other tax-exempt entities. Specifically, the Supplemental Guidance provides:

> 21. Question: Is an applicant who owns eligible energy property eligible to receive payment if the energy property is leased to a non-profit or otherwise ineligible entity?
>
> Answer: Yes. If the owner of the energy property is the applicant and is otherwise eligible, the fact that the property is being leased to an ineligible entity does not impact the eligibility of the owner/applicant provided it is a true lease and not a disguised sale.

This issue was not clear from the original Treasury Guidance issued in July 2009, which did not discuss governmental and tax-exempt leasing.

The Supplemental Guidance represents a significant departure from the investment tax credit ("ITC") rules, but one that is favorable to owners of renewable energy property. Under the ITC rules, energy property that is leased to governmental or tax-exempt entities is not eligible for the ITC. See I.R.C. §§ 50(b)(3), (4), 168(h). Moreover, proportional disallowance of the ITC results in the case of leases to partnerships with governmental or tax-exempt partners. I.R.C. §§ 50(b)(4)(D), 168(h)(5).

Governmental and tax-exempt entities have been and continue to be key participants in the renewable energy industry. Under the ITC rules, such entities cannot themselves claim the ITC, or, for that matter, the production tax credit under section 45 of the Internal Revenue Code (the "Code"). However, such entities invariably require outside financing. Tax equity investment has been and continues to be a critical financing tool for governmental and tax-exempt entities that require renewable energy. The planning opportunities for tax equity investment, however, are limited to service contract structures in which power is sold to the governmental or tax-exempt entities under long-term power purchase agreements.

The service contract rules under section 7701 of the Code require careful tax analysis and structuring. A “foot fault” under those rules could result in the arrangement being characterized as a lease and the ITC being disallowed. Moreover, some governmental entities are not permitted to enter into power purchase agreements. The Supplemental Guidance eliminates this ITC risk of recharacterization and permits equity investors and governmental/ tax-exempt entities to structure their transactions as leases from the outset and be eligible for the Treasury Grant, provided the depreciation consequences and the consequences under section 470 of the Code described below are properly considered.

Leasing to a governmental or tax-exempt entity still has its disadvantages. Although the Treasury Grant may be claimed by equity investors, the same tax-exempt use rules applicable to the ITC apply in the context of the depreciation rules. See I.R.C. § 168(h). The impact on depreciation is a longer recovery period (the longer of the class life (12 years for wind and solar energy) and 125% of the lease term as opposed to five years). A service contract recharacterized as a lease also would require meeting the section 470 rules applicable to tax exempt use losses. Finally, the equity investor must qualify as the tax owner of the renewable energy property and the lease must be structured carefully to ensure that it will be treated as a true lease for tax purposes.

It is important to make sure that the deal is properly structured because the lease to the tax-exempt will preclude the ability of the equity investor to claim the ITC in lieu of the Treasury Grant if a Treasury Grant, which cannot be requested until after the equity investor has placed the property in service as the original user, is not received. Also, Investors should be careful to structure their transactions in a manner to avoid the potential recapture of the Treasury Grant. Under the Treasury Guidance, a sale to a governmental or tax-exempt entity would result in recapture of the Treasury Grant if the energy property is sold within five years from the date the property is placed in service. As such, early termination buyouts may only occur after the five -year recapture period. Furthermore, the consequences of such early termination buyouts must be considered under the potential application of section 470.

Please read our prior client alert on the Supplemental Guidance and a copy of the Questions and Answers.

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