

Recent Developments Affecting Renewable Energy Projects

The month of March saw three generally positive developments for the renewable and alternative energy industry:

1. Guidance in connection with the codification of the economic substance doctrine, which at least grandfathers current market practice for financing renewable and alternative energy projects;
2. Revised guidance for the grant-in-lieu program, which makes it easier for applicants to obtain a grant from the Department of Treasury by demonstrating that construction of a renewable or alternative energy project commenced in 2010; and
3. A new Federal Energy Regulatory Commission (FERC) rule that exempts small electric generation facilities that are 1 MW or less from qualifying facility (QF) regulatory filing requirements. These developments are detailed below.

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Codification of Economic Substance Doctrine

Section 1409 of the **Health Care and Education Reconciliation Act of 2010** (the Health Care Act), enacted on March 30, codifies the economic substance doctrine by adding a new subsection 7701(o) to the Internal Revenue Code of 1986, as amended (the Code). The concern with this legislation from participants in the market for tax-motivated investing in renewable and alternative energy projects was that it would, perhaps inadvertently, overturn current market conclusions as to whether certain renewable and alternative energy financing structures pass muster for federal income tax purposes.

The general consensus is that the legislation does not have such a result, and accordingly, does not harm to current market practice.

The statutory language of Code Section 7701(o), as well as the relevant **explanation** issued by the Joint Committee on Taxation (JCT), clearly state that the determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the new provision does not change current standards for determining when to utilize an economic substance analysis.

Moreover, in a footnote, the JCT notes that tax benefits that are clearly consistent with the congressional purpose that the tax benefits were designed to effectuate will not be disallowed merely because the transaction fails the proposed economic substance test. Although this JCT explanation is not official legislative history, it is nonetheless persuasive.

This footnote, in whose drafting and inclusion Winston partner Jim Miller played a key role, states that it is, for example, not intended that a tax credit such as the section 42 low-income housing credit, the section 45 production tax credit, the section 45D new markets tax credit, the section 47 rehabilitation credit, or the section 48 energy credit be disallowed in a transaction pursuant to which

a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

Thus, the JCT explanation generally confirms that the codification of the economic substance doctrine is not meant to adversely affect those tax credit-motivated renewable and alternative energy financing structures that currently pass muster for federal income tax purposes.

At the same time, the JCT explanation does not describe any type of tax credit-motivated financing structure, and is generally not thought to expand current federal income tax law regarding the extent to which tax credits and other federal income tax benefits may form part of an investor's expected return. Accordingly, participants in transactions involving such tax-motivated investments should continue to closely examine and analyze proposed structures for economic substance, as codified.

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Revised Cash Grant Guidance

Grant payments from the Department of Treasury (Cash Grants) are available for renewable and alternative energy projects that are placed in service after 2010 and before the relevant credit termination date if the "construction" of the project commences during 2009 or 2010.

The initial guidance document (the Grant Guidance) issued by the Treasury Department contains a safe harbor, under which construction of a project is deemed to have commenced when more than 5 percent of the total cost of the Cash Grant-eligible property has been paid or incurred *by the applicant*. Under this initial Grant Guidance, amounts paid or incurred by an applicant to a contractor who manufactured or constructed all or part of the project for the applicant did not count toward meeting

the 5 percent threshold of the safe harbor for commencement of construction until the relevant project was delivered to the applicant.

On March 15, the Department of Treasury revised the **Grant Guidance**. The revised guidance now allows applicants to count costs paid or incurred by a contractor who manufactures or constructs the project for the applicant toward meeting the 5 percent threshold of the safe harbor for commencement of construction. This change is intended to make it easier for owners of renewable and alternative energy projects to meet the requirements of the safe harbor and demonstrate that construction of their projects commenced before the end of 2010 in order to be eligible for a Cash Grant.

To take advantage of this change in the Grant Guidance, it becomes critical that the relevant manufacturer or contractor be willing to disclose and represent its costs to the applicant. Developers of renewable and alternative energy projects that will be placed in service after 2010 should strongly consider reviewing their equipment supply contracts in order to design them to meet the requirements of the safe harbor for commencement of construction and thus grandfather the Cash Grant. Winston & Strawn professionals have been working with clients to ensure they do.

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New FERC Rule and Order

On March 19, FERC issued a new **rule** that exempts electric generation facilities with a capacity of 1 MW or less from the requirement to file for QF certification or recertification. FERC adopted the 1 MW exemption because it was concerned about the regulatory filing burden for smaller QFs, citing as an example roof-top solar panels on homes and hospitals. The exemption is universal and is not limited by fuel type.

Moreover, in an **order** issued on March 18, FERC declined to exempt New York State Electric & Gas from a mandatory obligation to purchase power from a small cogeneration facility operated by Cornell University because its output was temperature-sensitive, highly variable, and because it could not

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practically schedule its output for sale into the New York Independent System Operator (NYISO) day-ahead energy market without running the risk of significant under-scheduling penalties. The order emphasizes that FERC did not rule that variable weather or variable output are sufficient to preserve a utility's mandatory purchase obligation; rather, it states that the combination of the high variability in the need for Cornell's output, coupled with the way NYISO's markets work, particularly the risk of penalties, supported special treatment for Cornell.

The order shows that owners of renewable and alternative energy projects continue to face complex regulatory issues, including the obligation of the local utility to purchase the power produced by a project. Winston & Strawn professionals work with clients on these issues every day.

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