

# Client Alert

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## Treasury Releases Guidance Describing Process for Evaluating Cost Basis for Treasury Grant Purposes

On June 30, 2011, the Treasury Department released [guidance](#) describing the process for evaluating the cost basis of projects qualifying for a Treasury Grant under Section 1603 of the American Recovery and Reinvestment Act. The guidance “outlines the process used by the Section 1603 team to evaluate basis and the principles that guide this process.” Although the guidance addresses only solar PV properties, the guidance states that “the methods used to evaluate cost basis described herein apply to all types of properties.”

### Tax Concepts

According to the Treasury guidance, the principles used to evaluate cost basis for Treasury Grant purposes “are consistent with tax concepts used to determine basis for federal tax purposes.” The guidance confirms that, for federal tax purposes, basis for Treasury Grant purposes is generally the cost of the property and certain capitalized costs. However, Treasury states that it has authority to decide that “an applicant has miscalculated or misrepresented the basis of its property.” The Treasury cites the *ARRA Energy* case, which the Government lost in the U.S. Court of Federal Claims, as support for the exercise of this authority. *ARRA Energy Company I et al. v. United States*, 97 Fed. Cl. 12 (2011). Treasury states that “basis is more closely scrutinized in cases involving related parties, related transactions, or other unusual circumstances.”

### Benchmarks

Treasury states that the “first step” in evaluating the cost basis is “to compare the claimed basis to certain benchmarks.” Treasury indicates that the benchmarks for solar PV cost basis are predicated on “an open-market, arm’s-length transaction between two entirely unrelated parties with adverse economic interests, specifically with respect to setting the eligible property’s price.” As of the first quarter of 2011, Treasury is using the following benchmarks for solar:

	Residential	Residential/ Small Commercial	Commercial	Large Commercial/ Utility
<b>Size Range</b>	< 10 kW	10 – 100 kW	100 – 1,000 kW	> 1 MW
<b>Typical Size</b>	5 kW	25 kW	250 kW	2 MW
<b>Turnkey Price per W</b>	+/- \$7	+/- \$6	+/- \$5	+/- \$4

Treasury asserts that these benchmarks represent “a high quality of equipment (modules, inverters, racking) installed by reputable companies across the United States and include profit.”

Treasury informs us that such benchmarks are flexible and are designed to take into account a number of factors and projects specific characteristics. Treasury states that other factors, such as technology choice, regional market differences, differences in size and property-specific characteristics that increase (or decrease) eligible cost, are factors that also are considered.

### **Cost Higher Than Benchmarks**

Treasury states that “[a]pplications with a claimed basis that is materially higher than benchmarks will receive closer scrutiny.” The guidance states, “[i]n addition to ensuring that only eligible costs are included, the review team looks at whether there are related party considerations, or other unusual circumstances, such as where the transaction determining basis may be influenced by other related transactions.”

Treasury provides two examples of related party or other unusual circumstances:

1. As an example of a related transaction, Treasury points to “a case in which the benefits of a power purchase agreement are acquired at the same time the Section 1603 eligible property is acquired.”
2. Owner/applicant is a party to one or more related transactions with the developer such that economic interests in the specific transaction determining basis may not be adverse. For example, the owner/applicant purchased the energy property from the developer and leased the property back to the developer.

If these circumstances are present, Treasury indicates that it will evaluate whether the applicant’s cost basis is consistent with fair market value. Treasury will consider the applicant’s allocation of the cost to the eligible property, relative to other ineligible assets, rights or contracts that may have been explicitly or implicitly conveyed in the transaction(s). In this context, the owner/applicant may be asked to submit a more detailed cost breakdown. Specifically, original manufacturer’s invoices/costs to the developer should be provided for major equipment, subsequent markups by the developer should be enumerated and any markups by the owner identified. The owner may also submit a detailed and credible third-party appraisal (discussed below) demonstrating that the claimed basis is consistent with a market transaction between unrelated parties with adverse economic interests.

As an example of a related transaction Treasury points to “a case in which the benefits of a power purchase agreement are acquired at the same time the Section 1603 eligible property is acquired.” Thus, Treasury implies that a power purchase agreement may be treated as a separate intangible asset and that Treasury may take the position that some portion of the cost basis is allocable to that intangible asset.

Treasury states that “[i]f the review team determines that the basis was not properly calculated or represented, the review team may adjust the basis on which a 1603 payment is made to a level consistent with the review team’s view of the property’s true cost, as informed by documentation provided by the applicant and other relevant information and analysis.”

### **Fair Market Value**

Treasury confirms that “fair market value” is “the price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.” In determining fair market value, Treasury indicates that it will evaluate appraisals provided by the applicant and independent, certified appraisers with expertise in solar PV properties. Fair market value is evaluated using the cost approach, the market approach and/or the income approach.

### **Cost Approach**

Treasury states that the cost approach provides the “most concrete and supportable analysis” and is favored by Treasury because cost data for PV systems is increasingly timely and available. The cost approach is based on the actual cost to build the property. According to the guidance, this approach should clearly show the cost buildup, including hard costs, soft costs and profit.

*Markup.* Treasury states that it will accept a cost approach that includes only eligible property and a markup that is consistent with industry standards and with the scope of work for which the markup is received. The Treasury guidance states with respect to an appropriate markup:

While appropriate markups are case-specific and can depend on the ultimate transaction price, the 1603 review team has found that appropriate markups typically fall in the range of 10 to 20 percent. A cost approach that includes a markup should explicitly address the appropriateness of the selected markup in light of the activity, capital investment, and risk for which that markup is compensating.

**Market Approach**

The market approach is based on sales of comparable properties. Treasury states that thousands of solar PV properties have been installed in the last two years, and market data are readily available. Treasury cautions that “consideration must be given to ensuring that the prices of chosen comparables reflect only the value of eligible property.”

**Income Approach**

Treasury states that the income approach is “the least reliable method of valuation given the number of variables that are subject to speculation and open to debate.” The income approach is based on the discounted value of future cash flows generated by and appropriately allocable to the eligible property. Numerous assumptions must be made, including forecasts of all relevant project revenue and cost streams, cost of capital (debt and equity), rates of inflation and taxes, number of periods of income and residual value.

In Treasury’s view, “an income approach also often requires careful consideration of the appropriate allocation of value to the eligible energy property. In cases where the income approach yields a value that exceeds the cost to build the property by a significant margin, this raises a question of whether a portion of the claimed value should, in fact, be allocated to other ineligible assets, rights, or contracts associated with the production of income from the eligible property, such as a power purchase agreement.”

Treasury states that applicants can accelerate reviews of their applications by ensuring that appraisals adequately address the issue of appropriate allocation of basis to the eligible property. For example, appraisals should address the fair market value of the eligible property specifically, and not the “project” in which that property is being used. Treasury states that “a credible income approach to valuation will consist of a detailed spreadsheet model showing annual revenue and expenses over the term of the contract with a reasonable residual value at contract termination.”

According to Treasury, the key assumptions for the income approach are as follows:

- Inflation rates should be supported by credible sources.
- Discount rates should reflect an appropriate risk premium above the risk-free rate.
- Speculative revenue (i.e., revenue that is not specifically contracted and guaranteed by a creditworthy customer) will be closely scrutinized and must be well supported and documented. Projected revenue beyond contracted periods should be based on conservative, publicly available data.
- All expenses must be included, both annual ordinary operating expenses and major maintenance (e.g., inverter replacement).
- All depreciation, taxes and other considerations should be incorporated into the model.

Treasury indicates that these and all other assumptions should be well reasoned, should be sufficiently documented in the appraisal and should reflect market expectations. Moreover, Treasury states that the income approach in the appraisal should explicitly address the allocation of the estimated discounted cash flows to the eligible property.

The energy tax credits practice at Hunton & Williams routinely advises clients on energy tax credits and the Treasury grant program. Hunton & Williams represents and advises solar energy clients regularly before the IRS and the Treasury Department. Please contact us if you have any questions regarding this Treasury guidance or tax credits and the Treasury grant program, generally.

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