

Client Alert

March 2012

IRS Issues Published Guidance Relating to Section 1603 Treasury Grants

On March 12, 2012, the Internal Revenue Service (the "Service") issued Notice 2012-23 (the "Notice"), providing guidance in a question-and-answer format on tax-related issues involving cash payments under Section 1603 of the American Recovery and Reinvestment Act of 2009 ("ARRA").

Reductions in Basis

The Notice confirms that receipt of an incentive or subsidy in addition to a Section 1603 payment reduces the basis of the eligible property used in calculating the Section 1603 payment if the incentive or subsidy is excluded from the gross income of the recipient. The Notice also confirms that receipt of an energy conservation subsidy from a public utility that is excluded from gross income under Section 136 of the Internal Revenue Code (the "Code") will reduce the eligible basis used in calculating the Section 1603 payment amount. However, the Notice further confirms that receipt of a Department of Energy loan guarantee will *not* reduce the eligible basis.

Tax-Exempt Use Property Rules

The Notice confirms that Code Section 168(h)(6) applies to any partnership that owns property and has a tax-exempt entity or a tax-exempt controlled entity as a partner, even if the partnership is eligible for a Section 1603 payment. In general, Section 1603 is more restrictive with respect to tax-exempt partners, applying a total disqualification approach in contrast to the proportional reduction rules of Section 168(h)(5) and (6). On the other hand, in one respect, Section 1603 is less restrictive than Section 168(h)(6): Section 1603 does not require a tax-exempt controlled entity to be treated as a tax-exempt entity for purposes of determining eligibility for a Section 1603 payment. Thus, under Section 1603, a "blocker" corporation may be used without affecting eligibility for Treasury grants. The Notice also confirms that the percentage of the property that is tax-exempt use property is depreciated using the longer Alternative Depreciation System ("ADS") recovery periods, rather than the generally shorter periods under the Modified Accelerated Cost Recovery System ("MACRS").

Project Election

The Section 1603 program guidance permits an applicant to treat multiple units of property as a single property (the "Project Election") for purposes of determining the beginning of construction and the date the property is placed in service for purposes of Section 1603. The Notice confirms that the Project Election does not impact the determination of the unit of property or the date that property is placed in service for depreciation or tax credit purposes. Thus, in the context of energy property, the depreciation and tax credit rules must be applied on a "facility" basis and not on a project basis. See, e.g., Notice 2008-60, 2008-30 I.R.B. 178 (defining the "facility" for open-loop biomass purposes); Rev. Rul. 94-31, 1994-1 C.B. 16 (defining the "facility" for wind energy purposes).

Lessee Pass-Through Election and Sale-Leaseback Rules

The Notice also confirms, if a lessor and lessee elect to pass through the Section 1603 payment to the lessee (the “Lessee Pass-Through Election”), the lessor does not reduce depreciable basis by 50 percent of the amount of the Section 1603 payment, and the lessee must include in gross income, ratably over the five-year recapture period, an amount equal to 50 percent of the amount of the Section 1603 payment.

Additionally, the Notice confirms, if the three-month requirement under the sale-leaseback rules is not satisfied, the purchaser/lessor will not be permitted to make the Lessee Pass-Through Election. Instead, as confirmed by the Notice, the seller/lessee will be considered to have placed the property in service for purposes of Section 1603 and will receive the Section 1603 payment. Further, the seller/lessee is required to reduce the basis of the project by 50 percent of the amount of the Section 1603 payment before determining gain or loss on the sale of the project to the purchaser/lessor. However, the seller/lessee is not required to report income equal to 50 percent of the amount of the Section 1603 payment ratably over the five-year recapture period.

Key Takeaways

While much of the Notice is a restatement of understood items, the Notice does confirm the applicability of certain rules relating to energy tax credits and the Section 48 investment tax credit, including rules relating to reductions in eligible property basis, tax-exempt use property, the project election and the lessee pass-through election. The Notice is one of the few items of “published guidance” from the Service in the energy tax credit area. As the Notice is “published guidance,” taxpayers are permitted to rely on the guidance in planning their transactions and the guidance binds the Service on the points covered. On the other hand, the Notice contains a cautionary note that any guidance, documents, interpretations or approvals issued by Treasury relating to the Section 1603 program are not precedent for the federal income tax treatment of specified energy property under Sections 45 and 48 of the Code.

Click the following link for a copy of the [Notice](#).

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 energy clients regularly before the Internal Revenue Service and the Treasury Department. Please contact us if you have any questions regarding this Notice, energy tax credits or the Treasury grant program.

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