Treasury Releases Guidance on Evaluating the Cost Basis for 1603 Grant Purposes

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The U.S. Department of Treasury issued guidance to assist taxpayers with preparing Section 1603 grant applications by outlining the Treasury processes used to evaluate cost basis.

Recently, the U.S. Department of Treasury issued a document (Basis Guidance) intended to assist taxpayers in determining their cost basis in solar photovoltaic property for purposes of the cash grant provided by the Treasury pursuant to Section 1603 of the Recovery and Reinvestment Tax Act of 2009 (Grant). The Basis Guidance is intended to outline the process used by the Grant team at Treasury to evaluate basis and the principles guiding that process. Although the Basis Guidance only specifically addresses solar property, it indicates that the methods described apply to all types of properties. Below is a brief summary of the Basis Guidance, which can be found in its entirety here.

The Grant is generally equal to 30 percent of an applicant's basis in qualified energy property. See "Treasury Updates Section 1603 Cash Grant Guidance and Frequently Asked Questions" for more information.

The Basis Guidance is divided into two sections, one describing basis procedures and the other describing fair market value procedures. Determinations of the fair market value of property eligible for the Grant are generally relevant to the Treasury both to determine the Grant amount where the eligible property has been leased to the Grant applicant and to determine whether an applicant's cost basis is appropriate in a purchase context.

Basis

The Basis Guidance first indicates the Treasury will "closely scrutinize" stated cost basis on a Grant application where related parties, related transactions or other unusual circumstances are involved. The first step in the review process used by the Grant team is to compare the stated basis in the Grant application to certain benchmarks. The benchmarks are open-market, arm's length benchmarks that are continuously updated by the Treasury's Grant team using publicly available information (such as the U.S. Department of Energy's $1 per watt study, the California Solar Initiative and the Tracking the Sun report), expert analysis, data from other Grant applications and other confidential sources. As of the first quarter of 2011, the Basis Guidance lists benchmarks of +/– $4 per watt for commercial solar projects in excess of one megawatt, up to +/– $7 per watt for residential solar projects less than 10 kilowatts.

If the claimed basis on a Grant application is "materially higher" than the benchmarks, the team will then closely scrutinize whether only eligible costs were included, related party considerations and "other unusual circumstances," such as where the transaction determining basis may be influenced by other related transactions. One example of related transactions noted by the Basis Guidance is where a power purchase agreement is acquired at the same time the Grant-eligible property is acquired. This comment suggests that the Treasury is considering whether some of the cost basis should properly be allocated to a power purchase agreement. However, such an allocation seems to be inconsistent with the project-specific nature of the power purchase agreements generally involved in solar transactions.

Other unusual circumstances highlighted by the Basis Guidance include: applicant being related to the developer, installer or supplier, or applicant being a party to related transactions with the developer such that economic interests in the transaction determining basis may not be adverse (*i.e.*, in a sale-leaseback transaction with the developer). If these circumstances are present, the Grant team will evaluate allocation of cost to the eligible assets and may ask for more detailed cost breakdowns. Markups in the price by the developer or owner should also be identified and enumerated. The owner may also submit a detailed third-party appraisal demonstrating that the claimed basis is appropriate.

Fair Market Value

The Basis Guidance notes that the Grant review team does not prepare appraisals for energy property and merely evaluates appraisals provided by the applicants. In evaluating these appraisals, the Basis Guidance provides that, of the three methods typically used by appraisals to value energy property, the "Cost Approach" is the most concrete and supportable method. The Cost Approach is based on the actual costs to build the energy property. If a cost markup is included, the appraisal should explicitly address the appropriateness of the markup. The Basis Guidance indicates that appropriate markups in the solar property context typically fall in the range of 10 to 20 percent.

The other two approaches used by appraisers and discussed in the Basis Guidance are the "Market Approach" and the "Income Approach." The Market Approach is based on sales of comparable properties; the Basis Guidance warns that consideration should be given to ensuring the prices of the comparables reflect only the value of eligible property. The Income Approach, deemed the least reliable method based on the number of variables that go into its value determination, is based on the discounted value of future cash flows generated by and appropriately allocable to the eligible property. The Basis Guidance specifies that a credible Income Approach method 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.

Impact of Basis Guidance

The Basis Guidance should be complied with by Grant applicants because it represents the Treasury's view of appropriate cost basis determinations. The rules in the Basis Guidance were intended to be consistent with tax concepts used to determine basis for federal tax purposes, although the Basis Guidance is not itself a legislatively enacted statute or regulation.