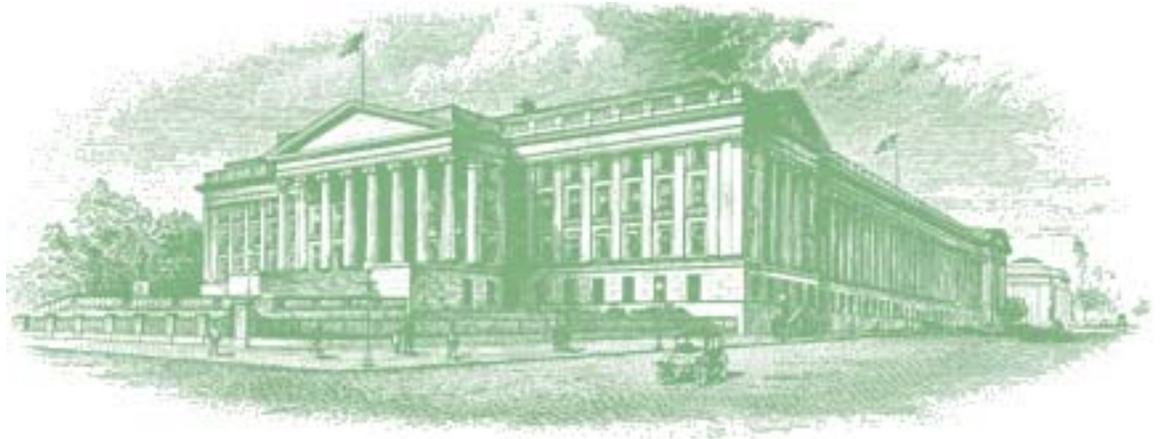




Audit Report



OIG-11-110

RECOVERY ACT: Audit of Pyron Wind Farm LLC Payment Under
1603 Program

September 28, 2011

Office of Inspector General

DEPARTMENT OF THE TREASURY

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Abbreviations

Energy	Department of Energy
E.ON	E.ON Climate and Renewables North America
IRS	Internal Revenue Service
NREL	National Renewable Energy Laboratory
OFAS	Office of the Fiscal Assistant Secretary
OIG	Office of Inspector General
Pyron	Pyron Wind Farm, LLC
Recovery Act	American Recovery and Reinvestment Act of 2009
Treasury	Department of the Treasury
Treas. Reg.	Treasury Regulation

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*The Department of the Treasury
Office of Inspector General*

September 28, 2011

Richard L. Gregg
Fiscal Assistant Secretary

As part of our ongoing audit coverage of the Department of the Treasury's (Treasury) 1603 Program – Payments for Specified Energy Property in Lieu of Tax Credits (1603 Program)¹ authorized by the American Recovery and Reinvestment Act of 2009 (Recovery Act),² we are conducting audits of selected award recipients. In this regard, we have audited the award made to Pyron Wind, LLC (Pyron) for a wind farm near Roscoe, Texas. Pyron submitted its claim for payment in lieu of tax credit in the amount of \$121,903,306 on September 13, 2009, and was awarded that amount by Treasury on September 21, 2009. Our audit objectives were to assess the eligibility and accuracy of that award by determining whether (1) the property existed, (2) the property was placed into service during the eligible timeframe, and (3) the award amount was appropriate.

Results in Brief

We verified that the subject property described by Pyron in its 1603 Program application does exist and that it was placed in service March 1, 2009, which was within the eligible timeframe. We also concluded that the award amount was appropriate after

¹ Treasury's Office of the Fiscal Assistant Secretary (OFAS) administers this program.

² Pub. L. No. 111-5, 123 Stat. 115 (Feb. 17, 2009). Under section 1603 of the Recovery Act, Treasury makes grants (payments) to eligible persons who place in service specified energy property and apply for such payments. The purpose of the payment is to reimburse eligible applicants for a portion of the expense of such property and is made in lieu of tax credits that could have been potentially claimed by the awardees.

management provided clarification of certain applicable tax provisions through its response to this draft audit report. In the draft report, we originally questioned \$1,199,804 of Pyron's \$406,344,352 reported cost basis (\$359,941 of the award amount) which related to spare parts and a spare parts data collection system. At the time we issued our draft report, we believed these costs were ineligible based on our initial interpretation of those applicable tax provisions.

After reviewing management's response, which clarified the applicable tax provisions governing spare parts, we no longer question their eligibility under the 1603 Program and make no related recommendations for Treasury. Pyron's and Treasury's management responses to our draft audit report are provided in appendices 1 and 2, respectively.

Background

Eligibility Under the 1603 Program

Applicants are eligible for a 1603 Program award if a specified energy property is placed in service during calendar years 2009, 2010, or 2011,³ and the amount awarded is in accordance with applicable provisions of the Internal Revenue Code of 1986 for determining cost basis. Under the 1603 Program, applicants submit an application to Treasury that reports the total eligible cost basis of a specified energy property placed in service. If approved, award amounts are based on a percent of that eligible cost basis. For the type of property claimed by Pyron, the percentage of cost basis eligible for award is 30 percent. According to OFAS program guidance, the cost basis of the subject property is determined in accordance with the general rules for determining the cost basis of property for federal income tax purposes. Specifically, for this type of subject property, applicants follow the capitalization procedures

³ Section 707 of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," extended Treasury's 1603 Program for 1 year. To be eligible, a property must be placed in service in 2009, 2010, or 2011 or placed in service after 2011 but only if construction of the property began during 2009, 2010, or 2011. The application deadline was extended to September 30, 2012.

found in Treas. Reg. §1.263A-1, "Uniform Capitalization of Costs."⁴

Pyron

Pyron is a 249 megawatt wind farm located near Roscoe, Texas. Pyron uses 166 General Electric 1.5SLE wind turbines; each 1.5SLE turbine has a rated capacity of 1.5 megawatts. Pyron's parent company is E.ON Climate and Renewables North America (E.ON) located in Chicago, Illinois, which also manages the Pyron wind farm.

Objectives, Scope, and Methodology

To assess the eligibility and accuracy of the award made to Pyron under the 1603 Program, we determined whether (1) the property existed, (2) the property was placed into service during the eligible timeframe, and (3) the award amount was appropriate.

In performing our work, we visited Pyron's parent company, E.ON in Chicago, Illinois; interviewed key personnel of E.ON and key personnel associated with its independent public accountant (IPA). We also reviewed the application, production reports, invoices, contracts and other documents provided to the Department of Energy's (Energy) National Renewable Energy Laboratory (NREL)⁵ to support the property's existence, its placed in service date, and the costs claimed by Pyron. We also obtained clarification from OFAS and Internal Revenue Service (IRS) personnel on eligible costs under the program. We performed our work between April and May 2011.

Our audit was conducted in accordance with generally accepted government auditing standards for performance audits. Those standards require that we plan and perform an audit to obtain

⁴ Treas. Reg. §1.263A-1(a)(3)(ii), Property produced: "Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business."

⁵ NREL is a national laboratory of the Department of Energy. Under an interagency agreement between Treasury and the Department of Energy, NREL performs the technical review of 1603 Program applications and advises Treasury on award decisions.

sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Results

Pyron submitted a cost segregation and Section 1603 payment eligibility analysis⁶ to Treasury that was prepared by E.ON's IPA on behalf of Pyron. The cost segregation analysis included the property's classification for depreciation purposes and all costs that made up its cost basis. The Section 1603 payment eligibility analysis identified \$406,344,352 of costs in the property's cost basis that Pyron believed were eligible for payment under Treasury's 1603 Program.

In our draft audit report, we originally questioned the appropriateness of Pyron's claimed costs of \$1,157,130 for spare parts and \$42,674 for a spare parts data collection in its cost basis that resulted in \$359,941 of its 1603 Program award. These items were purchased from late March 2009 through July 2009, subsequent to placing the subject property in service on March 1, 2009.⁷ After receiving clarification through Treasury management's response on the tax provisions governing spare parts, we no longer question the eligibility of spare parts under the 1603 Program.

Initially, it was our understanding that to be included in the cost basis, as specified in Treas. Reg. §1.263A-1, the parts must be necessary to produce the property. According to an IRS attorney we spoke to, spare parts and energy property are two separate assets with separate cost bases, and there is no justification in tax law for classifying these two assets as the same unit. As a result, the costs of the spare parts should not be included as part of Pyron's cost basis and are therefore questioned. Similarly, the cost

⁶ The cost segregation and Section 1603 payment analysis was prepared for the purposes of classifying property for Federal income tax depreciation or amortization purposes and determining the eligibility for a cash grant in lieu of tax credit provided by Section 1603 of the American Recovery and Reinvestment Act of 2009. The analysis included reviews of certain project cost data and engineering drawings provided by E.ON and discussions with management of E.ON.

⁷ Treasury Program Guidance, IV. Property and Payments Eligibility, A. Placed in Service... "Placed in service means that the property is ready and available for its specific use."

of the spare parts data collection system was not something that was necessary to place the subject property in service and is therefore questioned as well.

After reviewing our draft report, Pyron management did not concur with our assessment of the ineligibility of spare parts. In its response, Pyron stated that spare parts should be considered “specified energy property” as defined in Treasury’s 1603 Program Guidance⁸ and in Treas. Reg. §1.48-9(e)(1), and therefore, qualify for inclusion in the property’s cost basis. In addition to qualifying as energy property, spare parts are considered parts related to the functioning of the integrated wind farm, integral to the overall facility, and should not be viewed as a separate asset. Lastly, Pyron management believes that spare parts meet the definition of repairs and maintenance as defined by Treas. Reg. 1.263A-1(e)(3)(ii)(O), and that all spare parts included in the 1603 cost basis also meet the definition of “Emergency Spare Parts” as defined by Rev. Rul. 81-185. See appendix 1 for Pyron’s response.

Based on our evaluation of Pyron’s response, we maintained that spare parts and the subject energy property were two separate and distinct assets with separate cost bases and different “placed in service” dates. We believed at the time that the spare parts in question were not an integral part of the wind farm and should not have been considered specified energy property under Treasury’s 1603 Program. We based this on our interpretation of Rev. Rul. 81-185 which concludes that standby emergency spare parts are to be capitalized and depreciated when the parts are acquired and set aside as emergency replacement parts. Emergency spare parts are considered placed in service when they are placed in a condition or state of readiness and availability for an assigned function. Placed-in-service is addressed in Treas. Reg. §1.46-3(d)(2)⁹ which makes the distinction between the in service dates of materials and parts acquired for use in the construction of equipment and parts used as replacements to avoid time loss. In Pyron’s case, the spare parts in

⁸ Treasury’s Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009 Program Guidance, IV. Property and Payment Eligibility Part I. Types of Property

⁹ Treas. Reg. §1.46-3(d) establishes the placed in service rules for qualified investment property for investment tax purposes. Treas. Reg. §1.167(a)-11(e)(1)(i) references the provisions of Treas. Reg. 1.46-3(d)(1)(ii) and (d)(2) to determine the date property is placed in service.

question were not in a condition or a state of readiness and availability at the time of construction. Instead, they were considered replacements to avoid time loss since they were purchased after placing the subject property in service on March 1, 2009. Therefore, we believed that they should have been capitalized as separate depreciable assets.

Furthermore, Pyron's spare parts were not necessary to produce the subject property nor were they indirect repair and maintenance costs, as outlined in Treas. Reg. §1.263A-1, and they are not functionally interdependent components of the subject property. According to Treasury's Program Guidance, components of a larger property are a single unit if the components are functionally interdependent. Components are functionally interdependent if the placing in service of each component is dependent on the placing in service of the other component. Pyron's questioned spare parts were purchased, ready and available for their intended use after the subject property was placed in service and commercial operations had begun. Of the costs questioned, \$1,157,130 in spare parts was purchased on July 27, 2009. Accordingly, the spare parts were not functionally interdependent components of the subject property and could not be used to directly or indirectly produce the property already in service.

Therefore, our initial conclusion was that the spare parts in question were not necessary to place the subject property in service since they were purchased after commencing operations. In its response to our draft audit report, Treasury management provided a detailed clarification of the tax guidance on which we based our evaluation of the spare parts. Management concluded that the costs of the spare parts in question were eligible because they were a part of a qualified facility under IRC §45 and were in service at the time of the Pyron's 1603 Program application. See appendix 2 for Treasury's management response.

After receiving clarification on the tax provisions governing spare parts, we no longer question the eligibility of Pyron's spare parts.

* * * * *

The information in this report should not be used for purposes other than what was originally intended without prior consultation with the Office of Inspector General regarding its applicability. Information contained in this report may be confidential. The restrictions of 18 U.S.C. §1905 should be considered before the information is released to the public. We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss this report, you may contact me at (202) 927-5400 or Donna Joseph, Audit Director, at (202) 927-5784. Appendix 3 lists the major contributors to this report.

/s/

Marla A. Freedman
Assistant Inspector General for Audit

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Appendix 1
Pyron Wind Farm LLC's Response



June 16, 2011

Erica Wardley
Audit Manager
US Department of Treasury
Office of Inspector General

RE: Draft Audit Report of the Award Made to Pyron Wind Farm, LLC, Under the
Department of Treasury's 1603 Program – Payments for Specified Energy Property in
Lieu of Tax Credits

Dear Ms. Wardley:

This letter confirms E.ON Climate & Renewables, LLC's (the "Company") view that its
position on Pyron Wind Farm, LLC spare parts, as outlined in its letter to Ms. Marla
Freedman of the Department of the Treasury Office of Inspector General dated October
14, 2010, is still valid. The Company still supports and confirms the content of that letter,
which I have attached here for reference.

Please feel free to contact me with any further questions.

Best Regards,

A handwritten signature in blue ink that reads "Mark A. Frigo".

Mark A. Frigo
Vice President, Investment Analysis
E.ON Climate & Renewables, LLC

Appendix 1
Pyron Wind Farm LLC's Response



October 14, 2010

Ms. Maria A. Freedman
Assistant Inspector General for Audit
Department of the Treasury Office of Inspector General
740 15th Street, N.W., Suite 600
Washington, D.C. 20220

RE: Draft Audit Report of the Award Made to Pyron Wind Farm, LLC, Under the Department of Treasury's 1603 Program – Payments for Specified Energy Property in Lieu of Tax Credits ("Draft Audit Report")

Dear Ms. Freedman:

This letter represents the written response of E.ON Climate and Renewables North America LLC (the "Company") to the Draft Audit Report as requested by your letter dated September 29, 2010. The Draft Audit Report proposed an adjustment to eligible basis in the amount of \$1,199,804 related to spare parts. The purpose of this letter is to contest the proposed adjustment described above identified in the Draft Audit Report.

Facts

Pyron is owned by Pyron Wind Farm, LLC ("PWF LLC"), which is a subsidiary of the Company. The wind farm consists of 166 wind turbine generators, including spare parts, and supervisory control and data acquisition system were provided per the terms of a Turbine Supply Agreement titled Contract for the Sale of Power Generation Equipment and Related Services between GE and PWF LLC dated June 26, 2006 ("TSA Contract"). The TSA Contract also included provisions for the delivery of the spare parts that are necessary to have on site in order to keep the wind farm operating at 100% capacity at all times. The engineering, procurement, and construction of Pyron, including erection of the wind turbine generators, the procurement and construction of the on-site collection system and the procurement and construction of the Pyron Substation was provided through a construction contract for the balance-of-plant ("BOP") equipment and construction between PWF LLC and D.H. Blattner & Sons, Inc. dated December 14, 2007. The Pyron Substation was constructed as part of the BOP Contract.

The Company submitted a claim for payment in lieu of a tax credit under the Department of Treasury's ("Treasury") 1603 Program – Payments for Specified Energy Property in Lieu of Tax Credits (the "1603 Program") in the amount of \$121,903,306 on September 13, 2009 and was awarded this amount by Treasury on September 21, 2009. The Company's reported cost basis of such property was \$406,344,352 which included \$1,199,804 of spare parts.

Issue

The Draft Audit Report issued by the Treasury's Office of Inspector General ("OIG") states that the OIG does not believe the spare parts in the amount of \$1,199,804 comply with Treas. Reg. §1.263A-1.¹ Specifically the Draft Audit Report states:

¹ Unless otherwise indicated, all section or "§" references are to the U.S. Internal Revenue Code of 1986, as amended (the "Code"), and any references to regulation section or "§" are to the U.S. Treasury Department regulations under the Code ("Treas. Reg. §").

Appendix 1
Pyron Wind Farm LLC's Response

"To be included in the cost basis, as specified in Treas. Reg. §1.253A-1, the parts must be necessary to produce the property. According to an IRS attorney we spoke to, spare parts and energy property are two separate assets with separate cost bases, and there is no justification in tax law for classifying these two assets as the same unit. As a result, the costs of the spare parts should not be included as part of Pyron's cost basis and are therefore questioned...."

"As a result, we are questioning \$359,941 of Treasury's 1603 Program award to Pyron (30 percent of \$1,199,804). We are recommending that the Fiscal Assistant Secretary ensure that Pyron reimburses Treasury \$359,941 for the excessive 1603 Program payment received."

Law and Analysis

Treasury issued "Payments for Specified Energy Property in Lieu of Tax Credits Under the American Recovery and Reinvestment Act of 2009 Program Guidance" (the "Program Guidance") during July 2009 which was subsequently revised and re-issued during March 2010. The Program Guidance states the following:

"Property eligible to receive Section 1603 payments is "specified energy property." Specified energy property includes only tangible property (not including a building) that is an integral part of the facility. The tangible property is tangible personal property and other tangible property as defined in Treas. Reg. §1.48-1(c) and (d). Specified energy property is property for which depreciation (or amortization in lieu of depreciation) is allowable."

"Qualified property includes only tangible property that is both used as an integral part of the activity performed by qualified facility and located at the site of the qualified facility. Qualified property does not include a building but may include structural components of a building. Property is an integral part of a qualified facility if the property is used directly in the qualified facility, is essential to the completeness of the activity performed in that facility, and is located at the site of the qualified facility."

"Qualified property must be placed in service in 2009 or 2010 or, in the case of property placed in service after 2010 for which construction begins in 2009 or 2010, before the credit termination date. Property that satisfies this placed-in-service requirement may be qualified property even if it is an addition to or expansion of a qualified facility placed in service before 2009."

"The basis of property is determined in accordance with the general rules for determining the basis of property for federal income tax purposes. Thus, the basis of property generally is its cost (IRC section 1012), unreduced by any other adjustment to basis, such as that for depreciation, and includes all items properly included by the taxpayer in the depreciable basis of the property, such as installation costs and the cost for freight incurred in construction of the specified energy property."

"The owner of multiple units of property that are located at the same site and that will be operated as a larger unit may elect to treat the units (and any property, such as a computer control system, that serves some or all such units) as a single unit of property for purposes of determining the beginning of construction and the date the property is placed in service. In such a case, the entire cost of such larger unit of property is taken into account in applying the safe harbor. The owner may not include within this larger unit

Appendix 1
Pyron Wind Farm LLC's Response

any property that was placed in service before January 1, 2009. For example, the owner of a wind farm may treat as a single unit a wind farm that will consist of fifty turbines, their associated towers, their supporting pads, a computer system that monitors and controls the turbines, and associated power condition equipment. In cases where the applicant treats multiple units of property as a single unit, failure to complete the entire planned unit will not preclude receipt of a Section 1603 payment.¹

Taxpayers subject to §263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale.² Section 263A applies to property produced by a taxpayer.³ The term "produce" includes construct, build, install, manufacture, develop, or improve.⁴ The taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer, except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account.⁵

Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale).⁶ Taxpayers subject to §263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.⁷ Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.⁸ Repairs and maintenance expenditures are one such example of indirect costs that are required to be capitalized.⁹

Generally, property that would be eligible for an investment tax credit pursuant to §46 is eligible for a 1603 Program award, provided the property is placed in service in 2009 or 2010, or in the case of property placed in service after 2010 for which construction begins in 2009 or 2010, before the credit termination date. For purposes of §46, the energy credit for any taxable year is the energy percentage of the basis of energy property placed in service during such taxable year.¹⁰ Energy property includes wind energy property.¹¹ Wind energy property is equipment (and parts related to the functioning of that equipment) that uses wind energy to heat or cool, or provide hot water for use in, a building or structure, or uses wind energy to generate electricity.¹² In general, wind energy property consist of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items.¹³

Conclusion

The Company contests the proposed adjustment to cost basis related to spare parts in the amount of \$1,199,804 which would result in a refund to Treasury in the amount of \$359,941. The spare parts should be considered "specified energy property" as defined in the Program Guidance and under Treas. Reg. §1.48-9(e)(1). As specified in this regulation, and mentioned above in the Law and Analysis section, wind energy property consists of a windmill, wind-driven generators, storage devices, power conditioning

² Treas. Reg. §1.263A-1(e)

³ I.R.C. §263A(b)(1)

⁴ I.R.C. §263A(g)(1)

⁵ I.R.C. §263A(g)(2)

⁶ Treas. Reg. §1.263A-1(e)(3)(i)

⁷ Id.

⁸ Id.

⁹ Treas. Reg. §1.263A-1(e)(3)(ii)(O)

¹⁰ I.R.C. §48(a)(1)

¹¹ Treas. Reg. §1.48-9(e)(1)

¹² Treas. Reg. §1.48-9(e)(1) – (2)(i) and (ii)

¹³ Treas. Reg. §1.48-9(e)(1)

Appendix 1
Pyron Wind Farm LLC's Response

equipment, transfer equipment and parts related to the functioning of those items. In our case, the spare parts fall across those categories and certainly are considered parts related to the functioning of the integrated wind farm. If one of the parts on a wind turbine becomes inoperable, the spare parts are needed in order for the asset to remain functional. The spare parts were provided for under the wind turbine supply agreement with GE and were deemed by the Company to be a necessary component of the overall project. These spare parts are integral to the overall facility as they are required for ongoing repairs and maintenance of the wind turbines and are necessary to have on site in order to prevent the interruption of energy production during maintenance. It is a customary practice in this industry to have spare parts on site as most wind farms are located in remote locations of the U.S. and quick access to parts to provide routine and expected maintenance as well as the availability of items with long lead times is an essential business requirement. If one wind turbine becomes inoperable, it reduces the energy output of the integrated facility, resulting in less energy transferred to the grid and therefore less revenue to the Company. Therefore, it is imperative that the system be kept 100% available as much as feasible.

The spare parts are tangible personal property for which depreciation is allowable that are used as an integral part of the energy generation activity performed by a qualified facility and are located at the site of the qualified facility. Also, the spare parts should be viewed as a component of the overall unit of property that consists of the 166 wind turbines located on site. Since our overall unit of property is the integrated facility of 166 wind turbines and associated equipment, the spare parts should be viewed as a portion of this overall unit of property. The program guidance cited above allows an applicant to consider the entire wind facility to be considered one unit of property for purposes of this program. In the example in the program guidance, it is demonstrated that computer monitoring equipment is included in the overall larger unit of property. Computer monitoring equipment is arguably less integral to the actual production of energy than the specific spare parts that we have included as energy property in our application as our spare parts are directly involved in the production of energy.

Due to the nature of their existence, the spare parts would also meet the definition of a repair and maintenance expenditure as defined in Treas. Reg. §1.263A-1(e)(3)(ii)(O) and therefore would be required to be capitalized into the basis of the specified energy property pursuant to Treas. Reg. §1.263A-1(e).

Overall, the spare parts pool should not be viewed as a separate asset. By themselves, the spare parts hold little value to the Company. It is only when integrated into the larger unit of property that the spare parts can function and therefore, should be viewed as a smaller piece of a much larger asset.

Sincerely,

E.ON Climate & Renewables North America, LLC

By: 
Tom Festle, CFO

Appendix 2
Management's Response



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

Marla Freedman
Assistant Inspector General for Audit
Department of the Treasury
Office of Inspector General
740 15th Street, N.W., Suite 600
Washington, D.C. 20220

Dear Ms. Freedman:

Thank you for the opportunity to comment on the draft audit report of the Section 1603 award made to Pyron Wind Farm, LLC (Pyron). For the reasons stated below we do not concur with the recommendations contained in the report.

The draft report recommends that the Office of the Fiscal Assistant Secretary (OFAS) ensure that Pyron reimburse Treasury in the amount of \$359,941 from a Section 1603 payment of \$121.9 million made in October, 2009 for a wind farm located near Roscoe, Texas. This recommendation is based on a finding that Pyron improperly included in their claimed cost basis, costs for spare parts. The report concludes that the spare parts are a separate asset from the wind farm and therefore the cost of the spare parts should not be included in the basis of the wind farm. Section 1.263A-1 of the Income Tax Regulations which governs the capitalization of costs is cited as support for this view.

OFAS is advised by IRS Office of Chief Counsel staff that the relevant inquiry for determining whether or not the spare parts are eligible for the investment tax credit (and thus the Section 1603 payment) is not whether they are a separate asset but whether they are used as an integral part of the "qualified facility" (i.e., the wind farm). Section 1603 (d) (1) describes eligible property as any qualified property which is part of a qualified facility within the meaning of section 45 of the Internal Revenue Code (IRC). Qualified property is tangible property that is *used* as an integral part of the qualified facility (IRC section 48(a)(5)(D)). In this case the qualified facility is the wind farm which includes equipment and parts related to the functioning of that equipment that uses wind energy to generate electricity (Treas. Reg. section 1.48-9). Additionally, Revenue Rulings 81-185 and 69-201 establish that emergency and rotatable spare parts are an integral and essential part of the machinery they serve.

Treas. Reg. section 1.263A-1 requires taxpayers to capitalize into basis all costs of producing property. The report notes that the spare parts were purchased in March 2009 through July 2009, after the March 1, 2009 placed in service date of the wind farm and thus should not be considered a cost of producing the property. Spare parts are considered placed in service when ready and available for use (i.e. when acquired and located at or near the site of the machinery in which they will be used). The spare parts in this case were, therefore, placed in service during the same tax year as the property in which they will be used, prior to the Section 1603 application (submitted in September 2009), and within the Section 1603 time requirements

Appendix 2
Management's Response

related to placed in service dates. One could argue that the costs of the parts are not part of the cost of producing the qualified facility because the facility was placed in service without them. However, this kind of interdependence (i.e. whether or not the facility can commence operation without the property) is not the test for determining whether or not property is used as an integral part of the qualified facility. Treas. Reg. section 1.263A-1 does not require that taxpayers only capitalize costs for property that is necessary to commence operations. The test for qualifying under Section 1603 is whether the property is used as an integral part of the qualified facility (i.e. the facility for the production of electricity). Because the spare parts are used in the production of electricity they meet this test.

The Section 1603 guidance allows a taxpayer to elect to apply the placed in service standard to an aggregate of independent items of qualifying property that will be operated together at the same site but does not directly address how one determines when an aggregate of independent items is placed in service if the items separately start operation over a period of several months. Thus, the guidance provides, in essence, that the Section 1603 payment is available for the cost of any property that is, on the date of the application, both operational and performing a qualified function regardless of whether that property performs an interdependent or an independent function. The investment tax credit does not require a single unit of property and thus the investment tax credit would be allowed for the spare parts even if they were considered a separate unit of property provided they were placed in service during the time allowed and are used in the qualified activity (see Treas. Reg. section 1.46-3(d)(2)(i)).

In this case the spare parts are part of a qualified facility under IRC section 45 and were in service at the time of the Section 1603 application. It is therefore our view that Pyron could successfully defend against any attempts by OFAS to seek reimbursement for the costs of these parts.

Sincerely,



Richard L. Gregg
Fiscal Assistant Secretary

Appendix 3
Major Contributors To This Report

Donna Joseph, Director
Cynthia Milanez, Audit Manager
Erica Wardley, Audit Manager
James Hodge, Auditor-in-Charge
Cheryl Sroufe, Auditor
Lisa Carter, Auditor
Roberta Wright, Auditor
Myung Han, Referencer
Theresa Cameron, Referencer

Department of the Treasury

Assistant Secretary for Management of the Treasury,
Chief Financial Officer, and Chief Performance Officer
Fiscal Assistant Secretary
Deputy Chief Financial Officer
Director, Office of Accounting and Internal Controls
Deputy Director, Office of Performance Budgeting
Program Manager, Office of Fiscal Assistant Secretary

Office of Management and Budget

OIG Budget Examiner

E.ON Climate and Renewables North America

Vice President, Investment Analysis