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Legal Update
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ITC Beginning of Construction Guidance

On June 22, 2018, the US Internal Revenue Service ("IRS") released Notice 2018-59 ("Guidance"). The Guidance provides rules to determine when construction begins with respect to investment tax credit ("ITC") eligible property, such as solar projects. The Guidance was much awaited by the solar industry because the date upon which construction begins governs the determination of the percentage level of the ITC, which is ratcheted down for projects that begin construction after 2019.

In addition to applying to solar (and fiber-optic solar), the Guidance applies to the following energy generation technologies: geothermal, fuel cell, microturbine, combined heat and power, and small wind.

Overview of Beginning of Construction

The ITC percentage for a solar project is determined based on the year in which construction of the project begins, provided the solar project is also placed in service before January 1, 2024, as follows: (i) before January 1, 2020, 30%; (ii) in 2020, 26%; (iii) in 2021, 22%; and (iv) any time thereafter (regardless of the year in which the solar project is placed in service), 10%.

The Guidance is quite similar to existing guidance for utility-scale wind projects.[1] As expected and consistent with the wind guidance, the Guidance provides two means for establishing the beginning of construction of a solar project (and other ITC technology projects): (i) engaging in *significant physical work* either directly or by contract (the "Physical Work Method") or (ii) paying or incurring (depending on the taxpayer's method of accounting) *5%* of the ultimate tax basis of the project (the "Five Percent Method").[2] As is the case with wind, the Guidance provides that the IRS will apply *strict scrutiny* of the facts and circumstances to determine if the project was *continuously constructed* from the deemed beginning of construction date through the date the project is placed in service.[3]

Four-Year Placed-in-Service Window

The wind guidance provides a four-year window for the project to be completed and to avoid the scrutiny as to whether the construction was *continuous*. There had been speculation that the window for solar (or at least some classes of solar) would be shorter because the time to construct solar projects (especially rooftop solar) is generally shorter than the time to construct a wind project. In what is a relief to the solar industry, the Guidance provides solar and the other ITC technologies a four-year window as well.

What the four-year window means in conjunction with the ITC ratcheting down is that a taxpayer (e.g., a distributed generation solar developer) could purchase $5 million of racking that is paid for on December 31, 2019, and delivered to the taxpayer on April 15, 2020.[4] The taxpayer could then use the $5 million of racking in the construction of $100 million[5] of projects[6] (assuming the 5/100 ratio is maintained in each project), none of which reach "notice to proceed" until 2023 so long as the projects are placed in service by the end of 2023. That $100 million of projects would qualify for the 30% ITC.[7]

Detailed Discussion of the Physical Work Method

As discussed above, the Guidance provides two methods for establishing the beginning of construction. Under the Physical Work Method, a taxpayer can establish that construction has begun by starting physical work of a significant nature.

The Physical Work Method focuses on the nature of the work performed, not the amount or cost. The work must be performed with respect to property *integral to the production of electricity* (in contrast to the transmission of it). Items that are not integral include fencing, most buildings, and roads that are *not* used to transport equipment that is used to operate and maintain the energy property.[8]

The Guidance provides that the Physical Work Method can be satisfied by the manufacture off-site of components, mounting equipment, support structures such as racks and rails, inverters, step-up transformers[9] and other power conditioning equipment.[10] In terms of qualifying on-site work, the guidance provides a "non-exclusive list" that for solar includes the "installation of racks or other structures to affix photovoltaic panels, collectors or solar cells to a site."

There are two important caveats with respect to satisfaction of the Physical Work Method. First, the manufacture of items that are either in "inventory or are normally held in inventory by a vendor" does not satisfy the requirement. For instance, the manufacture of fasteners would not qualify as fasteners are normally held in inventory by vendors. Likewise, the manufacture of most solar panels would appear to not qualify. In contrast, manufacture of a custom step-up transformer does qualify because vendors do not hold custom step-up transformers in inventory.

The second caveat is that the work not directly performed by the taxpayer must be performed pursuant to a "binding written contract" that is executed prior to the work being started.[11] As related parties in many instances are separate taxpayers (e.g., a corporate parent and its wholly owned corporate subsidiary), project owners need to ensure that work done by a related party that is a separate taxpayer is performed under a binding written contract between the project owner and its affiliate.

To be treated as binding, the contract has to be binding under state law (e.g., not an option agreement) and damages cannot be *capped* at less than 5% of the contract value. That does not mean the project owner must always pay at least 5% of the contract value. For instance, if the contractor's actual damages were only 1% of the contract value, it would be sufficient, in the case of a breach, that the project owner would owe the actual damages (i.e., 1%). That is, the words "five percent" do not have to be included at all in the contract so long as the contract does not have any cap on the damages the project owner would owe the contractor for a breach.

Detailed Discussion of the Five Percent Method

Under the Five Percent Method, a taxpayer can establish that construction has begun by paying or incurring at least 5% of the total cost of the project. Whether an amount is treated as paid or incurred is determined under the Internal Revenue Code. Only costs included in the depreciable basis of the project are taken into account to determine whether the Five Percent Method is satisfied, and, like the Physical Work Method, only costs incurred with respect to property integral to the production of electricity are considered. Unlike the Physical Work Method, costs paid or incurred with respect to property that is inventory or normally held in inventory by a vendor, such as solar panels, would count toward satisfaction of the Five Percent Method.

The Guidance includes a favorable modification of the cost overrun rules as applied to solar projects and other ITC technologies. For wind, if there is a cost overrun such that the amount incurred toward satisfaction of the Five Percent Method with respect to a project comprising multiple turbines is less

than 5%, but at least 3%, of the actual project spend, the taxpayer can opt to not claim tax credits with respect to some of the turbines of the project until the remaining turbines for which the tax credits are claimed have a "total cost" that is not more than 20 times the amount incurred toward satisfaction of the Five Percent Method.[12] Under the Guidance for the ITC technologies, this reduction technique is likewise available to the extent the project can be segregated into "energy properties," and then some of those energy properties are excluded from the tax credits until the remaining "energy properties" for which the tax credits are claimed satisfy the Five Percent Method. However, there is no requirement that the costs incurred with respect to the project be equal to at least 3% of the total project spend. An "energy property" includes all components that must be placed in service at the same time in order to generate electricity.

For rooftop solar, all components "installed on a single rooftop" constitute a single energy property. This means for rooftop projects, developers need to be careful to not have the ultimate tax basis of the ITC eligible property exceed 20 times what was spent under the Five Percent Method as such an excess disqualifies all of the project from relying on the Five Percent Method. The Guidance notes that if the Five Percent Method is not available, the taxpayer could use the Physical Work Method if the facts support it.

Single Project

Multiple energy properties that are operated as part of a single project are treated as a single energy property for purposes of determining the beginning of construction. So, if construction begins on one PV system in 2019 (e.g., physical work is performed, or costs are incurred, with respect to a PV system), all PV systems that are operated together with that PV system will have a 2019 beginning of construction date.

Whether multiple energy properties are operated as a single project is a factual determination that is made as of the date the project is placed in service. The nonexclusive factors in the Guidance that multiple energy properties are operated as part of a single project are: (i) the energy properties are owned by a single legal entity; (ii) the energy properties are constructed on contiguous pieces of land; (iii) the energy properties are described in a common power purchase agreement or agreements; (iv) the energy properties have a common intertie; (v) the energy properties share a common substation; (vi) the energy properties are described in one or more common environmental or other regulatory permits; (vii) the energy properties were constructed pursuant to a single master construction contract; or (viii) the construction of the energy properties was financed pursuant to the same loan agreement.

Multiple energy properties that are operated as a single project may be disaggregated and treated as multiple separate energy properties for purposes of determining whether a separate energy property satisfies the continuity requirements discussed above. As noted above for rooftop solar, all components "installed on a single rooftop" constitute a single energy property, so the continuity requirements must be satisfied with respect to the entire project.

Transfers

The Guidance contains the same transfer rules that apply to utility-scale wind projects. These rules are premised on the fact that there is no statutory requirement that the taxpayer that starts the construction of the project be the taxpayer that places it in service. However, the IRS has a policy to discourage "trafficking" in equipment that qualifies a project under the Physical Work Method or the Five Percent Method, although such a policy is not reflected in the statutory language. Under these rules, a transfer of a "project" from one taxpayer to another does not cause a loss of begun construction status so long as either (i) the transferred assets are more than equipment and contracts to acquire equipment (e.g., the transferred assets include a power contract and land rights) or (ii) the transferor

before or after the transfer is more than 20% related to the transferee.

In a partnership context, this second prong can be satisfied with either a "profits" interest (i.e., a partner's share of the profits (which may or may not be matched by current cash distributions) and losses *or* a "capital" interest (i.e., what a partner is entitled to in a liquidation)). So, for instance, a transferor that receives a 20.1% capital interest and a 1% profits interest in the transferee would satisfy this requirement.

Conclusion

Overall, the Guidance is favorable and will allow the solar and other ITC industries to plan for project deployments through 2023. Nonetheless, the technical ambiguities and opportunities for foot faults in the Guidance necessitate technical sophistication in applying it.

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Endnotes

[1] The utility-scale wind guidance is discussed in our 2016 Legal Update.

[2] While either method is sufficient by itself, the wind industry tends to prefer the Five Percent Method because of its more objective nature. In addition, if the four-year placed-in-service window is not satisfied, the Five Percent Method provides more flexibility with respect to satisfying the "continuously constructed" requirement, which is discussed below.

[3] The "continuously constructed" requirement is not provided for in the statutory language; however, neither does the statute define when construction on a project begins. Effectively, the IRS's policy is to provide taxpayers with a definition of "beginning of construction" that they can be more certain they have satisfied (i.e., a safe harbor) than trying to satisfy the commonly understood meaning of *construction*, but, similarly, the IRS uses its discretion to impose a requirement not in the statutory language that taxpayers must "continuously construct" or complete the project within the four-year window.

[4] For arrangements that do not involve vendor financing, accrual method taxpayers can pay in one taxable year and receive delivery of the equipment three and a half months after payment and be deemed to have incurred the cost in the year of payment. Taxpayers need to take care that they are consistent with their existing method of accounting as to whether transfer of legal title, physical delivery or both are required to meet the requirement of delivery within three and a half months.

[5] The $100 million does not necessarily refer to the out-of-pocket construction costs. Rather, it refers to the "total cost" of the ITC eligible property (i.e., the amount on which ITC is claimed). For instance, the out-of-pocket construction costs may be $90 million, but if the projects are subject to fair market value sales of $100 million, then to meet the safe harbor the 5% is measured against the $100 million (not $90 million). The "total cost" does not include the cost of land because land is not "integral."

[6] There is not a specific requirement that the racking, in this example, be *intended for specific projects* (e.g., the rooftop project on the warehouse at 123 Main Street); rather, the Guidance provides that the taxpayer "may begin construction of an energy property with the intent to develop the energy project at a certain site and thereafter transfer components of property of the energy property to a different site."

[7] The Guidance has an effective date of "after December 31, 2018," but illustrates the four-year window with an example of a project that begins construction in 2018. *See* § 3.02 of the Guidance. The example concludes that the four-year window for such a project would be applied beginning in 2018. Thus, there is some ambiguity as to when the clock would start ticking for a project that begins construction in 2018.

[8] The Guidance provides no instruction as to the minimum amount of road used for operation and maintenance activities that must be built to constitute beginning construction; presumably, anything more than a *de minimis* amount should be sufficient; nonetheless, project developers would be well-served to build as much as they feasibly can given cost and

engineering constraints. Further, it has been an open question for years as to whether a road that was initially built for the transport of equipment that subsequently was only used to perform maintenance on a project every two years (i.e., the equipment is not used to "operate" the project) qualifies as "integral" for purposes of this rules. Fortunately, this has proven to be an academic question as most project roads are used to transport equipment that is involved in both operations and maintenance.

[9] There is some ambiguity as to whether the manufacture of a transformer that steps up the voltage to 69 kilovolts or more (as opposed to less than such amount) would satisfy the Physical Work Method. *Cf.* §§ 4.02(1) & 7.02(1) of the Guidance.

[10] It would appear that the IRS omitted storage from the list because it is the IRS's view that storage is only "energy property" (i.e., ITC eligible) if it is charged for its first five years of operations at least 75% a year by solar or another technology that qualifies for ITC (including a wind project that has elected the ITC in lieu of the production tax credit). *See* P.L.R. 201444025 (Oct. 31. 2014), which is discussed in our 2017 blog post. At the time of starting construction, a taxpayer would not be certain that the storage would be so charged, so the IRS may have determined it appropriate to not include it in equipment that the manufacture of constitutes the start of construction.

[11] There is some language that may suggest that the binding written contract must be executed prior to payment for the work as well (not just the performance). To avoid ambiguity, developers should consider entering into a binding written contract for physical work before either payment or work starts.

[12] *See* Notice 2014-46, § 5.01.

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