TAX CLIENT ALERT OCTOBER 4, 2018

IRS Issues Guidance on Section 48 Investment Tax Credit for Solar and Other Renewable Energy Facilities; Are Storage Facilities Next?

Introduction

In Notice 2018-59 (the "**Notice**") the U.S. Internal Revenue Service ("**IRS**") provided welcome guidance to solar and certain other renewable energy project developers (including those building customer-sited "behind the meter" projects) on the "beginning of construction" test under IRC Section 48 investment tax credit (the "**ITC**") rules. Recognizing the value of joining renewable generation with storage, and recent Private Letter Rulings that the IRS had issued to individual taxpayers on this topic, on September 20, 2018 Senators Tim Scott (R-SC) and Michael Bennet (D-Co) sent a letter to Treasury Secretary Mnuchin urging him to issue further guidance to clarify whether storage assets installed at an existing ITC-eligible solar or other facility also qualify for the credit.

Background

The Notice, and the Senators' letter, are the latest moves on the landscape of federal tax policy support for renewable energy, whose short terms and intervening Congressional indecision over the past two decades have resulted in 'boom and bust' cycles for project development. The June Notice helps guide the implementation of two recent federal laws which were in part intended to reduce that unpredictability. The first law – the 2015 Consolidated Appropriations Act – included a 'grand bargain' under which the largely expiring ITC (and the already expired production tax credit (the "**PTC**") for wind and certain other renewable energy technologies) were extended for five years (with a phasedown) in return for lifting the 1976 ban on the U.S. export of crude oil. The second law – the Bipartisan Budget Act of 2018 – reinstated the ITC and PTC for the other technologies that had historically been eligible for the credits, and in certain ways otherwise modified the ITC, in part by replacing the requirement to place energy property in service by a certain date with a requirement to begin construction by a certain later date.

In general, the ITC (and the PTC) is phased down depending on the dates that the taxpayer begins construction and the property is placed into service. For example, solar property is eligible for the 30% ITC so long as a project begins construction prior to January 1, 2020 and is placed in service by January 1, 2024. However, the ITC is reduced to 26% for a solar project beginning construction in 2021 that is placed in service by January 1, 2024.

The Notice in General

The Notice provides two methods for a taxpayer to establish the beginning of construction for purposes of the ITC: (1) the "**Physical Work Test**" and (2) the "**5% Safe Harbor**." Both methods require that a taxpayer make continuous progress towards completion (the "**Continuity Requirement**").

Importantly, the Notice clarifies that although a taxpayer may satisfy both the Physical Work Test and the 5% Safe Harbor, construction will be deemed to have begun on the date that the taxpayer first satisfies one of the two methods. For example, if a taxpayer satisfies the Physical Work Test in 2018, and then satisfies the 5% Safe Harbor in 2019, construction will be deemed to begin in 2018.

Physical Work Test

In general, construction begins when physical work of a significant nature begins. For this purpose, work performed by both the taxpayer and work performed for the taxpayer under a binding written contract for use by the taxpayer in the taxpayer's trade or business should be taken into account.

The Physical Work Test depends on the nature of the work performed, not the amount or the cost. The Notice recognizes, *inter alia*, the following types of activities as qualifying "work" for a solar facility: the manufacture of components, mounting equipment, and support structures (e.g., inverters and transfers) and the installation of racks or other structures to affix photovoltaic panels, collectors, or solar cells to a site. However, "preliminary activities" such as planning or designing and securing financing, and even certain physical onsite work such as subsurface testing, clearing and grubbing, are not included even if their cost might otherwise be properly included in the depreciable basis of the energy property.

5% Safe Harbor

In general, construction begins when the taxpayer pays or incurs 5% of the total cost of the energy property. All costs included in the depreciable basis of such property should be taken into account (including the costs of preliminary activities which would not be taken into account for purposes of the Physical Work Test). However, the costs of non-integral property such as land or fencing should not be included.

Most importantly, for purposes of the 5% Safe Harbor taxpayers should be able to purchase equipment equal to 5% of anticipated costs in 2019 to permit property placed in service before January 1, 2024 to qualify for the 30% ITC. However, if the total cost of property ends up exceeding its anticipated total cost, such that the amount a taxpayer actually paid or incurred turns out to be less than 5% of the total cost, then the 5% Safe Harbor will not have been satisfied.

Continuity Requirement

As discussed above, both the Physical Work Test and the 5% Safe Harbor require that the taxpayer satisfy the Continuity Requirement. For purposes of the Physical Work Test, the Continuity Requirement requires that the taxpayer maintain a continuous program of construction. For purposes of the 5% Safe Harbor, the Continuity Requirement requires that the taxpayer makes continuous efforts to advance towards completion of the property.

Importantly, the Notice provides a 'Safe Harbor' for meeting the Continuity Requirement. If a taxpayer places property in services by the end of a calendar year that is no more than four calendar years after the calendar year during which construction of the property began, then the property will be treated as satisfying the Continuity Requirement. For example, if construction begins on property on January 15, 2018, and the property is placed in service by December 31, 2022, the property will be treated as satisfying the Continuity Requirement. However, if the property is not placed in service by December 31, 2022, whether the Continuity Requirement is satisfied will be determined by the relevant facts and circumstances.

Increased role for storage joined with renewable generation

Meanwhile, Colorado, Massachusetts, New York, and Rhode Island are among the U.S. states which are continuing or initiating policy support for "solar-plus-storage" systems, reflecting a growing recognition that joining storage with solar and other renewable generation can be a cost-effective, grid-friendly way to incorporate renewable generation technologies into the electricity supply, especially as part of variable-source solar and wind projects. Although the IRC does not explicitly reference energy storage (and thus stand-alone energy storage systems do not qualify for the ITC), in 2013 the IRS issued a Private Letter Ruling that recognized that expenditures for energy storage equipment, when paired with the simultaneous construction of a solar photovoltaic generation system, would be included in the Section 48 definition of a "qualified solar electric property expenditure" and thus eligible for the ITC. In March, 2018 the IRS issued another Private Letter Ruling recognizing that under IRC Section 25D (providing credit for certain expenditures which improve energy efficiency at residential properties), a storage facility added to a previously installed solar installation would be eligible for the credit. However, Private Letter Rulings only apply to the requesting taxpayer, and do not establish precedent.

As Senators Scott and Bennet note, in 2015 the IRS had sought public comment on whether further regulations defining which types of energy qualifying property should qualify for the ITC, including storage. In their September 20, 2018 letter the Senators state, "[b]y making these clarifications the IRS can ensure the full utilization of these domestic energy resources, thereby maximizing the public benefit of the tax incentive and bolstering grid reliability and energy security for the future."

Conclusion

The Notice is an encouraging development for renewable energy project developers and is likely to maintain and even spur investment in solar and other renewable energy projects. Meanwhile, clients are advised to watch closely for future guidance from the IRS regarding whether storage systems that are subsequently added to such projects will also be deemed eligible for the ITC.

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