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IRS Issues Beginning of Construction Guidance for Solar

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On June 22, 2018, the Internal Revenue Service (the "IRS") issued Notice 2018-59, which provides long-awaited guidance on when construction of energy property will have begun for purposes of the Investment Tax Credit ("ITC") under section 48 of the Internal Revenue Code (the "Code").

The guidance is similar in many respects to the beginning of construction guidance issued for wind facilities and other facilities that are eligible for the PTC under section 45 of the Code or the ITC in lieu of the PTC (the "Prior Guidance"). Although the rules in Notice 2018-59 should be familiar to those who have worked with the Prior Guidance, this client alert covers the applicable rules in detail. Furthermore, this client alert will focus on solar PV projects, though Notice 2018-59 also applies to solar hot water, fiber-optic solar, geothermal, fuel cell, qualified microturbine, CHP, small wind, and geothermal heat pump property.

At the end of this client alert, we provide a brief overview of the strategies for beginning construction on solar projects that we expect to be widely used.

Background

The applicable percentage for the ITC for a solar project depends on when construction on the property begins and when the project is placed in service. The percentage is 30% if construction begins before 2020, 26% if construction begins in 2020, and 22% if construction begins in 2021, in each case, as long as the property is placed in service before 2024. If construction begins after 2021, or if the property is placed in service after 2023, the percentage is 10%. Notice 2018-59 includes a useful chart covering the applicable dates for solar and other relevant projects.

Two Methods for Beginning Construction

Notice 2018-59 provides two methods by which a taxpayer can satisfy the beginning of construction requirement: (i) starting physical work of a significant nature (the "Physical Work Test") or (ii) incurring 5% or more of the costs of the facility (the "5% Safe Harbor"). Both methods require that a taxpayer make continuous progress toward completion once construction has begun (the "Continuity Requirement").

Although a taxpayer may satisfy both methods of establishing the beginning of construction, construction will be deemed to have begun on the date the taxpayer first satisfies one of the two methods. Notice 2018-59 provides that this rule applies "to energy property the construction of which begins, as determined under the earlier of either

the Physical Work Test or the 5% Safe Harbor, after December 31, 2018." Unfortunately, the effective date rule is inconsistent with an example in Notice 2018-59, which applies the alternate method rule to a taxpayer that satisfies the Physical Work Test in 2018 and the 5% Safe Harbor in 2019. Accordingly, it appears that either the effective date rule or the example is incorrect.

Physical Work Test

The Physical Work Test requires that a taxpayer begin physical work of a significant nature.

- *No Fixed Minimum*. Note that the test requires that the taxpayer "begin" (as opposed to complete or make substantial progress toward the completion of) physical work of a significant nature. As Notice 2018-59 states, (i) the Physical Work Test focuses on the nature of the work performed, not the amount or the cost and (ii) assuming that physical work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold required to satisfy the Physical Work Test. This is consistent with the Prior Guidance and with public statements from IRS and Treasury officials with respect to the wind guidance.

- *Work Under Binding Written Contract*. Work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract that is entered into before the manufacture, construction, or production of the property is taken into account to determine whether construction has begun.

- *On-Site and Off-Site Work*. Both off-site and on-site work may be taken into account. Generally, off-site physical work of a significant nature may include the manufacture of components, mounting equipment, support structures such as racks and rails, inverters, and transformers and other power conditioning equipment. If a manufacturer produces components of property for multiple energy properties, a reasonable method must be used to associate individual components of property with a particular purchaser. On-site physical work of a significant nature for solar energy property may include the installation of racks or other structures to affix solar panels, collectors, or solar cells to a site. Notice 2018-59 also provides examples of on-site work for other types of projects.

- *Inventory*. Physical work of a significant nature does not include work (whether performed by the taxpayer or another person) to produce components of energy property that are either in existing inventory or are normally held in inventory by a vendor.

- *Preliminary Activities*. Physical work of a significant nature does not include certain preliminary activities, even if the cost of the activities is included in the depreciable basis of the energy property. Preliminary activities include, among other things, planning, designing, obtaining permits, engineering, conducting environmental studies, excavating to change the contour of the land (as distinguished from excavation for a foundation), and removal of old energy property.

5% Safe Harbor

The 5% Safe Harbor requires that a taxpayer pay (if using the cash method) or incur (if using the accrual method) 5% or more of the total cost of the energy property.

- *The Numerator of the 5% Safe Harbor*. The applicable requirements for "paying or incurring" a cost are highly technical and filled with traps for the unwary. *It is very important to have tax counsel review supply agreements and other contracts the costs of which are intended to satisfy the 5% Safe Harbor* .

- *The Denominator of the 5% Safe Harbor*. All costs properly included in the depreciable basis of the energy property are taken into account to determine whether the 5% Safe Harbor has been met. The total cost of the energy property does not include the cost of land or any property not integral to the energy property. See below for a discussion of what property is integral to the production of electricity.

- *Cost Overruns – Single Energy Property*. If the total cost of a single energy property exceeds its anticipated total cost, so that the amount a taxpayer actually paid or incurred with respect to the single energy property as of an earlier year is less than 5% of the total cost of the single energy property at the time it is placed in service, then the taxpayer will not satisfy the 5% Safe Harbor with respect to any portion of the single energy property in such earlier year. See below for a discussion of what is treated as a single energy property for this purpose.

- *Cost Overruns – Single Project with Multiple Energy Properties*. If the total cost of an energy property that is a single project comprised of multiple energy properties exceeds its anticipated total cost, so that the amount a taxpayer actually paid or incurred with respect to the single project turns out to be less than 5% of the total cost of the single project when it is placed in service, the 5% Safe Harbor is not fully satisfied. However, the 5% Safe Harbor will be satisfied with respect to some, but not all, of the energy properties comprising the single project, as long as the total aggregate cost of those energy properties is not more than 20 times greater than the amount the taxpayer paid or incurred. Although not entirely clear, there does not appear to be any requirement that the property, the costs of which were paid or incurred by the taxpayer to satisfy the 5% Safe Harbor, be incorporated into the energy properties for which the ITC is claimed. To mitigate the risk of cost overruns, most taxpayers will incur an amount equal to 6-8% of projected costs.

- *Look-Through Rule*. Under the so-called "Look-Through Rule," a taxpayer may take into account amounts paid or incurred by a contractor. For property that is manufactured, constructed, or produced for the taxpayer by another person under a binding written contract with the taxpayer, amounts paid or incurred with respect to the property by the other person before the energy property is provided to the taxpayer are deemed paid or incurred by the taxpayer when the amounts are paid or incurred by the other person for federal income tax purposes.

Continuity Requirement

Where a taxpayer has satisfied the Physical Work Test, the Continuity Requirement requires that the taxpayer maintain a continuous program of construction, which involves continuing physical work of a significant nature. Where a taxpayer has satisfied the 5% Safe Harbor, the Continuity Requirement requires that the taxpayer make continuous efforts to advance toward completion of the energy property. In each case, whether the Continuity

Requirement is satisfied depends on the relevant facts and circumstances.

Certain disruptions in a taxpayer's continuous construction or continuous efforts to advance toward completion of an energy property that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to satisfy the Continuity Requirement. Notice 2018-59 provides a non-exclusive list of these "excusable disruptions."

Notice 2018-59 provides a safe harbor (the "Continuity Safe Harbor") pursuant to which the Continuity Requirement is deemed to be satisfied if a taxpayer places an energy property in service by the end of a calendar year that is no more than four calendar years after the calendar year during which construction of the energy property began (the "Continuity Safe Harbor Deadline"). The excusable disruption rules do not apply for purposes of applying the Continuity Safe Harbor. For example, if construction begins on an energy property on January 15, 2018, and the energy property is placed in service by December 31, 2022, the energy property will satisfy the Continuity Safe Harbor.

Under the so-called "disaggregation rule", multiple energy properties that are treated as a single project may be disaggregated and treated as multiple separate energy properties for purposes of the Continuity Safe Harbor. The disaggregated energy properties that are placed in service before the Continuity Safe Harbor Deadline will be eligible for the Continuity Safe Harbor. The remaining disaggregated energy properties may satisfy the Continuity Requirement under the facts and circumstances determination.

Because the facts and circumstances tests for the Continuity Requirement are difficult to apply in practice, we expect that most taxpayers will ensure that they satisfy the Continuity Safe Harbor.

Unfortunately, Notice 2018-59 did not include an additional safe harbor provision pursuant to which the Continuity Requirement would be deemed to be satisfied with respect to projects placed in service before 2020, notwithstanding that there was such a rule in the Prior Guidance. As a matter of statutory interpretation, it seems clear that if a solar project is placed in service before 2020, construction on that project must also have begun before 2020, and therefore the Continuity Requirement should be satisfied.

Transfers

A taxpayer that owns energy property on the date it is originally placed in service may elect to claim the ITC even if the taxpayer did not own the energy property when construction began, though any ITC is limited to the taxpayer's basis in the energy property. Accordingly, the general rule is that a fully or partially developed energy property may be transferred without losing its qualification under the Physical Work Test or the 5% Safe Harbor. However, an exception provides that if a transferor transfers solely tangible personal property (or contractual rights to such property under a binding written contract) to an unrelated transferee, the transferee cannot take into account work performed or amounts paid or incurred by the transferor for purposes of the Physical Work Test or the 5% Safe Harbor. For this purpose, whether a transferor and transferee are related is determined under section 197(f)(9)(C) of the Code, which at a high level requires 20% overlapping ownership. Accordingly, for a transferee to take into account the physical work performed by or the costs incurred by a transferor, either the transferee and transferor must be related or the transferred property must include project assets other than tangible personal property or the rights to acquire tangible personal property (e.g., land rights, a PPA, an interconnection agreement,

etc.).

A special rule provides that if a taxpayer begins construction of an energy property with the intent to develop the energy property at a certain site, and thereafter transfers the energy property to a different site, the taxpayer may take into account the work performed or the amounts paid or incurred before the site transfer for purposes of the Physical Work Test or the 5% Safe Harbor.

Retrofits

Notice 2018-59 applies the so-called "80/20 Rule" for purposes of determining whether retrofitted energy property qualifies for the ITC. Under the 80/20 Rule, energy property may qualify as originally placed in service even though it contains some used components if the fair market value of the used components of property is not more than 20 percent of the energy property's total value. For this purpose, the total value is the cost of the new components of property plus the value of the used components of property, and the cost of new property includes all properly capitalized costs. In the case of a single project comprised of multiple energy properties, the 80/20 Rule is applied to each energy property comprising the single project.

For purposes of the beginning of construction requirement, the Physical Work Test and the 5% Safe Harbor are applied only with respect to the work performed on, and amounts paid or incurred for, new property that is integral to the energy property. For the 5% Safe Harbor, all costs properly capitalized in the basis of the energy property are taken into account.

Other Rules

- *Single Energy Property*. Applying Notice 2018-59 requires identifying separate "energy properties". Notice 2018-59 treats all components of property that are functionally interdependent (unless such equipment is an addition or modification to an energy property) as a single energy property. (The parenthetical, which appears in the Notice, appears to acknowledge that after-installed equipment of a type that would otherwise be functionally interdependent—*e.g.*, a replacement inverter—can be placed in service independently.) Components of property are functionally interdependent if the placing in service of each component is dependent upon the placing in service of each of the other components in order to generate electricity. Citing Rev. Rul. 94-31, which treats each wind turbine, together with its tower and foundation, as a single unit of property, Notice 2018-59 concludes that all components of property necessary to generate electricity up to and including the inverter generally are treated as a single energy property. For rooftop solar energy property, all property integral to the generation of electrical energy that is installed on a single rooftop is considered a single unit of property.

- *Single Energy Project*. For purposes of the begin construction test, multiple energy properties that are operated as part of a single project (along with any components of property, such as a computer control system, that serves some or all such energy properties) will be treated as a single energy property. Whether multiple energy properties are operated as part of a single project depends on the relevant facts and circumstances applicable to the energy properties, including whether they are (i) owned by a single entity; (ii) constructed on contiguous pieces of land; (iii) described in a common PPA; (iv) have a common intertie; (v) share a common substation; (vi) described in the same environmental or other regulatory permits; (vii) constructed pursuant to a single

master construction contract; or (viii) financed pursuant to the same loan agreement. Whether multiple energy properties are operated as part of a single project is determined in the calendar year during which the last of the multiple energy properties is placed in service.

- *Property Integral to Energy Property*. Notice 2018-59 provides that only physical work on, and costs paid or incurred with respect to, property integral to the production of electricity will be taken into account for purposes of the Physical Work Test and 5% Safe Harbor, respectively. PV panels, mounting equipment, support structures, tracking equipment, monitoring equipment, other power conditioning equipment, and inverters are all integral to the production of electricity. Transmission property (including a transmission tower) is not integral to the production of electricity, but a transformer that steps up the voltage of electricity produced at an energy property to the voltage needed for transmission is integral because it is power conditioning equipment. Although not clearly stated, Notice 2018-59 appears to adopt a rule pursuant to which transmission means transmission at 69kv or greater. Following the Prior Guidance, Notice 2018-59 also provides that (i) onsite roads that are used for equipment to operate and maintain the energy property are generally integral to the production of electricity and (ii) roads primarily for access to the site, or roads used primarily for employee or visitor vehicles, fencing, and buildings are generally not integral to the production of electricity.

- *Binding Written Contracts*. Notice 2018-59 follows the definition of "binding written contract" from the Prior Guidance. For this purpose, a written contract is binding only if it is enforceable under local law against the taxpayer or a predecessor and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). A contractual provision that limits damages to an amount equal to at least 5% of the total contract price will not be treated as limiting damages to a specified amount.

- *Master Contracts*. Notice 2018-59 follows the master contract rule from the Prior Guidance. Under that rule, if a taxpayer enters into a binding written contract for a specific number of components of property to be manufactured, constructed, or produced for the taxpayer by another person under a binding written contract (the master contract), and then through a new binding written contract (the project contract) assigns its rights to certain components of property to an affiliated special purpose vehicle that will own the energy property for which such components of property are to be used, work performed or amounts paid or incurred with respect to the master contract may be taken into account in determining when construction begins with respect to the energy property.

Strategies for Beginning Construction

Notice 2018-59 suggests there are several strategies for beginning construction on a solar facility.

- *Purchase of Solar Modules*. Taxpayers can satisfy the 5% Safe Harbor by purchasing solar modules or other equipment for their projects. This could be a key part of the "begin construction" strategy for residential solar developers.

- *Installation of Posts and Racking*. Taxpayers looking to satisfy the Physical Work Test could install posts and/or

racking, which is clearly discussed in Section 4.02(2)(a) of Notice 2018-59. Taxpayers could do so directly, through a standalone construction agreement, or as part of an EPC contract.

- *Custom-Made Transformer*. Taxpayers can enter into a supply agreement for the construction of a custom-made transformer. This strategy was contemplated in the Prior Guidance and widely used for wind projects. The strategy is clearly contemplated in Section 7.02(1) of Notice 2018-59.

- *Construction on Roads*. Section 7.02(2) of Notice 2018-59 states that "onsite roads that are used for equipment to operate and maintain the energy property" are integral to the production of electricity. Although a similar rule applied in the Prior Guidance, the statutory language applicable to PTC-eligible facilities is different from that applicable to solar facilities (which, among other things, suggests solar energy property is limited to equipment). In Notice 2018-59, the IRS has taken the position that roads should qualify as solar energy property, notwithstanding the differences in the applicable statutory language. For utility-scale solar projects, construction on O&M roads may be a viable strategy for beginning construction.

For more information, contact any of the attorneys listed in this advisory.

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