Client Alert

June 2018

IRS Issues Beginning of Construction Rules for Purposes of the Investment Tax Credit under Section 48 of the Internal Revenue Code

On June 22, 2018, the Internal Revenue Service (the "IRS") issued Notice 2018-59 (the "Notice"), which provides guidelines and a safe harbor for purposes of determining when construction has begun on energy property under Section 48 of the Internal Revenue Code (the "Code"). Under the Consolidated Appropriations Act of 2016, Congress extended the Investment Tax Credit ("ITC") for solar energy property until January 1, 2022, and adopted a "beginning of construction" deadline in lieu of the placed-in-service ("PIS") deadline for solar facilities. Under the Bipartisan Budget Act of 2018, Congress extended the ITC for fiber-optic solar, qualified fuel cell, qualified microturbine, combined heat and power systems ("CHP"), qualified small wind, and geothermal heat pump property, until January 1, 2022, and replaced the PIS deadline with a "beginning of construction" deadline for these types of energy properties.

As modified, the ITC for solar and other energy property is subject to a phase down. The following tables summarize the requirements to qualify for the ITC for each type of energy property.

Solar

Began construction before January 1, 2020	PIS before January 1, 2024	ITC Amount = 30%
Began construction before January 1, 2021	PIS before January 1, 2024	ITC Amount = 26%
Began construction before January 1, 2022	PIS before January 1, 2024	ITC Amount = 22%
Began construction before January 1, 2022	PIS on or after January 1, 2024	ITC Amount = 10%
Began construction on or after January 1, 2022	PIS on any date	ITC Amount = 10%

Fiber-optic Solar, Qualified Fuel Cell, and Qualified Small Wind Energy

Began construction before January 1, 2020	PIS before January 1, 2024	ITC Amount = 30%
Began construction before January 1, 2021	PIS before January 1, 2024	ITC Amount = 26%
Began construction before January 1, 2022	PIS before January 1, 2024	ITC Amount = 22%
Began construction before January 1, 2022	PIS on or after January 1, 2024	ITC Amount = 0%
Began construction on or after January 1, 2022		ITC Amount = 0%

Qualified Microturbine, CHP, and Geothermal Heat Pump

Began construction before January 1, 2022	PIS on any date	ITC Amount = 10%
Began construction on or after January 1, 2022		ITC Amount = 0%

Geothermal

Began construction on any date	PIS on any date	ITC Amount = 10%

The Notice provides rules substantially similar to the "beginning of construction" rules applicable to Production Tax Credits ("PTCs") for wind energy projects. Similar to the "beginning of construction" rules for wind energy projects, the Notice generally provides two methods for establishing that construction has begun: a taxpayer may establish the beginning of construction by either (1) starting physical work of a significant nature (the "Physical Work Test"), or (2) paying or incurring 5 percent or more of the total cost of the facility (the "5 percent Safe Harbor"). Both methods require a taxpayer to make continuous progress towards completion once construction has begun (the "Continuity Requirement"). For energy property with a beginning of construction date after December 31, 2018, construction will be deemed to begin on the date the taxpayer first satisfies one of the two methods.

Physical Work

Similar to the "beginning of construction" rules for wind energy projects, the IRS has included the following guidance with respect to the Physical Work Test:

- To satisfy the Physical Work test, a taxpayer must:
    - start physical work of a significant nature, and
    - maintain a continuous program of construction.
- Physical work of a significant nature must be on ITC-eligible property. The Notice provides that only physical work of a significant nature on tangible personal property and other tangible property used as an integral part of the facility counts.
    - For example, physical work on, or costs paid or incurred for, a transmission tower will not count. Components integral to a facility include onsite roads that are used for equipment to operate and maintain the energy property, but exclude fencing and buildings (subject to certain exceptions).
- Work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract ("BWC") that is entered into before the work starts is taken into account.
    - A contract is binding only if it is enforceable under local against the taxpayer (or a predecessor) and does not limit damages to an amount equal to at least 5 percent of the total contract price.
- The Physical Work Test focuses on the nature of the work performed, not the amount or cost. If the physical work is of a significant nature, there is no fixed minimum amount of work or monetary threshold necessary to satisfy the Physical Work Test.

- Both off-site and on-site work may be taken into account in satisfying the Physical Work Test.
    - Off-site work of a significant nature may include the manufacture of components, mounting equipment, support structures such as racks and rails, inverters, and transformers (used in electrical generation that step up the voltage to less than 69 kilovolts) and other power conditioning equipment.
        - Off-site work (performed by the taxpayer or another person) counts as physical work only if (1) the manufacturer's off-site work is performed pursuant to a BWC and (2) the equipment manufactured is not existing in inventory or held in inventory by a vendor.
        - Similar to the "beginning of construction" rules for wind energy projects, the Notice contains a "Master Contract Rule." Under this rule if a taxpayer enters into a BWC for a specific number of components to be manufactured, constructed, or produced by another person and then, through a new BWC, assigns its right 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, the work under the master contract may be taken into account in determining whether the taxpayer satisfies the Physical Work Test.
            - The Notice does not define the amount of ownership required for a special purpose vehicle to be "affiliated," but presumably the use of the word "affiliated" infers greater than 80 percent common ownership is required.
    - The Notice provides a non-exclusive list of on-site work that is considered significant in nature for different types of energy property, including for:
        - *solar energy property*: installation of racks or other structures to affix photovoltaic (PV) panels, collectors, or solar cells to a site;
        - *fiber-optic solar energy property*: installation of collectors, concentrators, tracking systems, bundles of optical fibers, or fixtures within a structure;
        - *geothermal property*: physical activities undertaken at a project site after a valid discovery such as the installation of piping, turbines, generators, flash tanks, or heat exchangers;
        - *qualified fuel cell property*: installation of components of a fuel cell stack assembly such as electrodes, gas diffusion layers, membranes, gasketing, or plates;
        - *qualified microturbine property*: installation of gas turbine engine, combustor, recuperator, regenerator, generator, alternator, or other plant components;
        - *CHP property*: installation of a heat engine, generator, heat recovery components, or electrical interconnections;
        - *qualified small wind energy property*: installation of a foundation, tower, wiring, or grounding systems; and
        - *geothermal heat pump property*: installation of ground heat exchangers, heat pump units, or air delivery systems (ductwork).

- Physical work of a significant nature does not include preliminary activities such as planning, designing, financing, exploring, researching, conducting mapping and modeling to assess a resource, obtaining permits and licenses, conducting geophysical, gravity, magnetic, seismic and resistivity surveys, conducting environmental and engineering studies, developing a geothermal deposit prior to valid discovery, clearing a site, conducting test drilling to determine soil condition, excavating to change the contour of the land, or removing existing foundations, turbines, and towers, solar panels or any components that will no longer be part of the energy property.

5 Percent Safe Harbor

The Notice contains the same general 5 percent Safe Harbor rule as contained within the "beginning of construction" rules for wind energy projects.

- To satisfy the 5 percent Safe Harbor a taxpayer must:
    - pay or incur (within the meaning of Treas. Reg. § 1.461-1(a)(1) and (2)) 5 percent or more the total cost of the energy property before January 1, 2022; and
    - make "continuous efforts" to advance towards completion of the energy property (the "Continuous Efforts Test"), as described in more detail in the Continuity Requirement section below.
- The Notice allows a "look through" of economic performance under Section 461 of the Code for property that is manufactured, constructed, or produced for the taxpayer by another person under a BWC with the taxpayer.
    - Pursuant to the example provided in the Notice, only one level of "look through" is allowed, i.e., costs paid or incurred by a subcontractor to a contractor under a BWC with the taxpayer do not count.
- Similar to the Physical Work Test, costs of any property not integral to an energy property are not included in the total cost of energy property.
- The Master Contract Rule, as described in the Physical Work Test above, applies for purposes of satisfying the 5 percent Safe Harbor.
- Similar to the "beginning of construction" rules for wind energy projects, if cost overruns on a single project that consists of multiple energy properties result in the 5 percent Safe Harbor not being met, an ITC may be claimed with respect to a portion of the energy properties as long as the aggregate cost of those properties is not more than 20 times greater than the amount the taxpayer paid or incurred before January 1, 2022.

Continuity Requirement and Continuity Requirement Safe Harbor

- To satisfy the Continuity Requirement for the Physical Work Test, a taxpayer must maintain a continuous program of construction (the "Continuous Construction Test").
    - A continuous program of construction involves continuing work of a significant nature, which will be determined by relevant facts and circumstances.
    - The Notice provides a non-exclusive list of examples of when disruptions in the taxpayer's program of construction will not affect satisfaction of the Continuous Construction Test, including:

  - delays due to severe weather conditions or natural disasters;
  - licensing and permitting delays (including delays at the written request of a governmental agency regarding matters of safety, security or similar concerns);
  - labor stoppages;
  - interconnection-related delays;
  - delays in the manufacture of custom components and the inability to obtain specialized equipment;
  - presence of endangered species;
  - financing delays and delays due to supply shortages.

- To satisfy the Continuity Requirement for the 5 percent Safe Harbor, a taxpayer must meet the Continuous Efforts Test.
  - "continuous efforts" include paying or incurring additional amounts included in the total cost of the energy property, entering into BWCs for the manufacture, construction, or production of components of property or for future work to construct the energy property, obtaining necessary permits, and performing physical work of a significant nature.
  - The taxpayer may endure similar disruptions as provided under the Continuous Construction Test that will not cause the taxpayer to fail the Continuous Efforts Test.

- The Notice provides a safe harbor for satisfaction of the Continuous Construction and Continuous Efforts Tests (the "Continuity Requirement Safe Harbor").
  - The Continuity Requirement Safe Harbor is met if a taxpayer places energy property in service by the end of a calendar year that is no more than 4 calendar years after the calendar year during which construction of the energy property began.
  - If energy property is not PIS before the end of the 4th calendar year, whether the taxpayer satisfies the Continuity Requirement will be determined by relevant facts and circumstances.
  - Fiber-optic solar, qualified fuel cell, and qualified small wind energy property must be PIS before January 1, 2024. Solar energy property PIS after January 1, 2024 is eligible for a reduced ITC. The Continuity Requirement Safe Harbor does not extend these deadlines.

Single Project

- Solely for purposes of the "beginning of construction" rules, multiple energy properties that operate as part of a single project will be treated as a single energy property, taking into account various facts and circumstances.
  - The Notice enumerates the same 8 non-exclusive factors as provided in the "beginning of construction" rules for wind energy projects.

80/20 Rule

- Similar to the "beginning of construction" rules for wind energy projects, the Notice allows retrofitted energy properties to satisfy the "beginning of construction" rule for ITC-eligible property through either the Physical Work Test or the 5 percent Safe Harbor.
    - Both the Physical Work Test and the 5 percent Safe Harbor are applied only with respect to new components of property used to retrofit used components of property or an existing energy property.
        - For purposes of the 5 percent Safe Harbor, all costs properly capitalized in the basis of energy property are taken into account.

Transfer of Energy Property

- A taxpayer that owns energy property on its original PIS date may elect to claim the ITC with respect to the energy property, even if the taxpayer did not own the energy property at the time construction began.
    - A fully or partially developed energy property may be transferred without losing its qualification under the Physical Work Test or 5 percent Safe Harbor.
- A taxpayer may also begin construction at one site and thereafter transfer components of the energy property to a different site, complete the development and place it in service. The work performed or amounts paid or incurred prior to the transfer may be taken into account for either the Physical Work Test or the 5 percent Safe Harbor.
- If a transfer of tangible personal property (or contractual rights to such property under a BWC) occurs between parties that are not related—if the same person (directly or indirectly) does not own more than 20 percent of the profits and capital interests in both parties—any work performed or amounts paid or incurred by the transferor with respect to such transferred property will not count for purposes of either the Physical Work or 5 percent Safe Harbor Tests.

If you have any questions regarding the Notice, please contact us:

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