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IRS Unveils Start of Construction Rules for Solar, Other ITC-Eligible Technologies

The IRS released long-awaited guidance for developers of solar and other projects that qualify for federal investment tax credits on June 22, 2018, saying that a project will be considered to have begun construction if its owner commences "physical work of a significant nature," or pays or incurs (according to its method of accounting) at least five percent of the total cost of the project. The new rules, which are discussed in detail below, also address ancillary issues like project transfers and repowerings.

The year in which a project starts construction matters because it determines the value of the investment tax credit for which the project qualifies.

The guidance is in IRS Notice 2018-59. It affects developers of solar, fiber-optic solar, geothermal, fuel cell, microturbine, combined heat and power, small wind, and geothermal heat pump projects.

The year in which a project starts construction matters because it determines the value of the investment tax credit for which the project qualifies. Investment tax credits are worth a percentage of a taxpayer's basis in energy property that it places in service in a particular year.

For solar projects, the percentage is 30 percent if the project has started construction by the end of 2019. It dips to 26 percent if the project does not start construction until 2020, and 22 percent if the project does not start construction until 2021. If construction does not start until 2022 or later, or is not placed in service before 2024 (irrespective of when construction starts), the percentage is limited to 10 percent.

The phasedowns for fiber-optic solar, fuel cell, and small wind projects are generally the same as solar, except that no credit is available if construction begins in 2022 or later, or if the project is not placed in service before 2024.

Combined heat and power, microturbine, and geothermal heat pump projects qualify for a 10 percent investment tax credit as long as construction starts before 2022. The credit expires after that.

Geothermal projects are entitled to a permanent 10 percent investment tax credit. They may alternatively qualify for production tax credits in certain circumstances.

The IRS said in a 2016 notice relating to wind and other projects that qualify for the production tax credit that it anticipated issuing specific guidance for solar projects. Until now, there was little that developers of solar and other investment tax credit-eligible assets could do to plan for 2019, except try to draw analogies from existing wind guidance. That approach proved correct, as the new IRS guidance is like a start of construction "greatest hits," pulling in concepts that have been refined

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over six sets of guidance from 2013–2017. The rules follow the principles set out in the wind guidance in most respects.

Until now, there was little that developers of solar and other investment tax credit-eligible assets could do to plan for 2019, except try to draw analogies from existing wind guidance.

Here is how the rules work:

Physical Work Test

One way to start construction is by performing "physical work of a significant nature." The IRS has consistently maintained that this test focuses on the nature of the work performed as opposed to the amount or cost. There are no bright line rules.

A developer does not have to do the work itself as long as the work is performed under a binding written contract that is entered into before the work starts.

A written contract is generally binding if it is enforceable under local law and does not limit damages to less than five percent of the contract price. A termination for convenience provision that permits the buyer to walk away for free, for example, would not be binding. The contract should clearly state the work to be done and the price. Contractual amendments can be dangerous in this area, as a substantial modification would call the binding nature of the original contract into question.

Both on-site and off-site work counts.

The IRS gave the following examples of on-site work that would qualify:

- Solar – installation of racks or other structures to affix photovoltaic panels, collectors, or solar cells to a site.
- Fiber-Optic Solar – installation of collectors, concentrators, tracking systems, bundles of optical fibers, or fixtures within a structure.
- Geothermal – physical activities that are undertaken at a project site after a valid discovery such as the installation of piping, turbines, generators, flash tanks, or heat exchangers.
- Fuel Cell – installation of components of a fuel cell stack assembly such as electrodes, gas diffusions layers, membranes, gasketing, or plates.
- Microturbine – installation of a gas turbine engine, combustor, recuperator, regenerator, generator, alternator, or other plant components.
- Combined Heat and Power – installation of a heat engine, generator, heat recovery components, or electrical interconnections.
- Small Wind Energy – installation of a foundation, tower, wiring, or grounding systems.
- Geothermal Heat Pump – installation of ground heat exchangers, heat pump units, or air delivery systems (ductwork).

The IRS said that off-site work of a significant nature generally includes 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 kV), and other power conditioning equipment. However, consistent with IRS guidance in the production tax credit context, physical work is not significant if it includes the manufacturing of components that are either in existing inventory or normally held in inventory of a vendor. It is critical that any off-site work not run afoul of this rule.

Consistent with previous guidance, the IRS clarified that preliminary activities do not count, even if their cost is properly included in the basis of the property.

Physical work of a significant nature is limited to property that is considered "integral" to the production of electricity. It does not include property used for transmission. Roads qualify only if they are onsite and used to operate and maintain the property. Roads used to access the site or that are used primarily for employee or visitor vehicles do not count. Buildings generally do not count unless they are functionally an item of equipment or they house the energy property and are expected to be removed when the energy property they house is removed. Fencing does not count.

Also consistent with previous guidance, the IRS clarified that preliminary activities do not count, even if their cost is properly included in the basis of the property. Examples include planning or designing, securing financing, exploring, researching, conducting mapping and modeling to access a resource, obtaining permits and licenses, conducting geophysical, gravity, magnetic, seismic and resistivity surveys, conducting environmental and engineering studies, performing activities to develop a geothermal deposit prior to valid discovery, clearing a site, conducting test drilling to determine soil condition (including to test the strength of a foundation), and removing existing foundations, turbines, towers, solar panels, or any components that will not be part of the project (including those attached to a building structure).

Five Percent Test

The other way to start construction is by paying or incurring at least five percent of a project's total cost.

The "payment" standard is only available to cash method developers, which are typically individuals. Entities like partnerships and corporations generally use the accrual method of accounting and will only be able to count costs when they are treated as incurred for tax purposes.

"Total cost" means all costs included in a project's depreciable basis. It does not include costs for land or costs for property that is not integral to the project under the rules described above.

Cost overruns can cause a project to fail the five percent test, so it is generally better to aim for something like six or seven percent to build a cushion.

Accrual method taxpayers cannot incur costs before "economic performance" occurs. Economic performance generally occurs when an item is delivered or

accepted, or when title passes. The exact method depends on the taxpayer's method of accounting. An exception to this rule permits a taxpayer to count a payment for property as an immediate cost if the taxpayer can expect delivery or passage or title (preferably both) to occur within three and a half months of the payment. Use of the three and a half month rule is a method of accounting that would have to be used consistently by the taxpayer for all purposes.

Both the physical work test and the five percent test require work to continue once it starts. The guidance calls this a "continuity requirement."

Delivery does not necessarily have to be at the project site. It can be at the manufacturer's factory as long as it is clear that the buyer has really taken possession of the property. For example, the property should be physically separated from the property of the seller and other buyers, and the buyer should take out insurance covering risk of loss.

If a developer cannot establish that the five percent test is met based on its own costs, the rules permit it to look through to the contractor's costs, provided that the work was performed under a binding written contract.

The guidance is clear that mixing start of construction methods is generally not allowed. A developer is deemed to start construction on the date the first of the two tests is satisfied, and is stuck with that method moving forward. However, this rule does not go into effect until 2019, so there appears to be some optionality between now and the end of 2018.

Continuity Requirement

Both the physical work test and the five percent test require work to continue once it starts. The guidance calls this a "continuity requirement."

In the physical work test context, the requirement is for a "continuous program of construction" that involves continuous physical work. It is determined based on facts and circumstances. It is virtually impossible to prove unless physical work is literally happening every day.

The five percent test version of this concept is called "continuous efforts." It is also based on facts and circumstances, but is theoretically easier to prove. It involves continuing to incur costs, entering into binding contracts to complete the project, obtaining necessary permits, and performing physical work of a significant nature.

As with the production tax credit guidance, there are certain "excusable delays" that will not count against the taxpayer for purposes of determining whether work was continuous. They include things like natural disasters, permitting delays, financing delays, and supply shortages.

Fortunately for developers, the rules also include a safe harbor concept imported from the production tax credit rules that says the continuity requirement will be deemed satisfied as long as a project is placed in service within four calendar years after the year in which construction starts. For example, if work starts in 2019, the

test is met as long as the project is placed in service by the end of 2023. If the project is not placed in service in time, the developer is stuck having to prove continuous work or continuous efforts based on facts and circumstances.

The safe harbor dovetails nicely with the phasedown rules, which in several cases require a project to be placed in service before 2024 to qualify for a credit (or a credit above 10 percent in the case of solar). It is also a longer period than some expected (a four-year construction period for a solar project is relatively long, for example), but reflects an intent to put investment tax credit-eligible and production tax credit-eligible technologies on equal footing.

Similar to the production tax credit guidance, multiple energy properties that are operated as part of a single, integrated project are treated as a single project for purposes of testing when construction started.

Large Projects

Similar to the production tax credit guidance, multiple energy properties that are operated as part of a single, integrated project are treated as a single project for purposes of testing when construction started. Energy property is described in the guidance as including all components that are functionally independent (i.e., all of them are needed in order to generate electricity).

Whether multiple energy properties should be considered a single project depends on the facts. Facts that point to a single project include common ownership by a single legal entity, construction on contiguous pieces of land, common offtake, a common intertie, a common substation, common permits, common construction contracting, and common financing.

Larger projects are often completed in phases that begin in different years. These kinds of phased projects rarely have enough commonalities (e.g., common financing and common ownership) that would require single project treatment. In such cases, each phase would be its own project with an independent construction start date.

Transfers

Like the production tax credit guidance, the rules permit the taxpayer to transfer property after construction begins without losing tax credit eligibility.

The formation of a typical tax-equity partnership is not a problem. For example, a developer can contribute a five percent test-qualified project to a wholly owned limited liability company, a tax-equity investor can acquire a membership interest in that company, and then the company can claim tax credits based on the developer's prior tax credit qualification when the project is placed in service.

A purchaser of a partially developed project can take the seller's costs or work into account for purposes of the physical work test or five percent test. However, if the purchase consists solely of equipment (as opposed to equipment plus other development rights, like land or an interconnection queue position), the purchaser can only take the seller's work or costs into account for purposes of the start of construction rules if they are "related." For the parties to be related, there would need to be overlapping

ownership between the seller and purchaser of more than 20 percent. An unrelated purchaser of a project that includes development rights will have no problem.

Repowerings

The guidance also explains how the start of construction rules work for developers who want to refit old projects with new equipment so that they qualify for tax credits. Property is treated as "new" when at least 80 percent of the total value of the property's components consist of new components. This is referred to colloquially as the "80/20 rule."

The guidance also explains how the start of construction rules work for developers who want to refit old projects with new equipment so that they qualify for tax credits.

The guidance confirms that for a single project consisting of multiple interdependent assets, the 80/20 rule is applied on a property-by-property basis. For start of construction purposes, the physical work test or the five percent safe harbor is determined by looking at the cost of the new components. To use an example from the production tax credit guidance (which applies the same concept), if upgrades cost $15.4 million, the five percent test is met if the taxpayer incurs new costs of at least $770,000 (i.e., five percent of the cost of the new property).

The new guidance will be published in the Internal Revenue Bulletin on July 9, 2018.

The IRS will not issue private letter rulings for start of construction issues.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland author or your regular Kirkland contact.

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