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Renewable Energy Projects: Maximizing Investment and Production Tax Credits

Strategies for Leveraging Federal Tax Benefits, Incentives, and Recent IRS Guidance

THURSDAY, AUGUST 13, 2020

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PTCs / ITCs - Overview

Section 45 – Production Tax Credit (PTC)

Tax credit for each kWh of electricity that is (i) produced from a qualified energy resource at a qualified facility and (ii) sold to an unrelated third party during that taxable year

- 10-year period
- Current rate for 100% PTC wind – 2.5 c/kWh

Section 48 – Investment Tax Credit (ITC)

Tax credit calculated as a percentage of the tax basis of each energy property placed in service during that taxable year

- Solar, fiber-optics solar, fuel cells – 30%
- Geothermal, CHP – 10%
- 50% basis reduction
- 5-year recapture period

PTC Extension in 2019

- The PTC was set to expire for wind projects that did not "begin construction" prior to January 1, 2020
- On December 20th, 2019 the Further Consolidated Appropriations Act of 2020 was signed into law
- PTCs for wind projects were provided an unexpected 1-year extension.
  - Projects that began construction before the end of 2016 – 100%
  - Projects that began construction in 2017 – 80%
  - Projects that began construction in 2018 – 60%
  - Projects that began construction in 2019 – 40%
  - Projects that begin construction in 2020 – 60%
  - Projects that begin construction after 2020 – zero

No Solar ITC Extension

- The Further Consolidated Appropriations Act of 2020 did not extend the ITC for Solar projects. Current ITC phasedown schedule:
  - Projects that began construction before the end of 2019 – 30% ITC
  - Projects that begin construction in 2020 – 26% ITC
  - Projects that begin construction in 2021 – 22% ITC
  - Projects that begin construction in 2022 and after – 10% ITC
  - Projects that began construction before 2022 but are “placed in service” after 2023 – 10% ITC

Other PTC Extensions

The Further Consolidated Appropriations Act of 2020 also extended the PTC and ITC, in lieu of PTC, for the following technologies, which had previously expired if construction did not begin before the end of 2017. Now these projects need to begin construction by the end of 2020 to qualify

- Closed-loop biomass
- Open-loop biomass
- Geothermal energy
- Landfill gas
- Municipal solid waste
- Incremental hydropower
- Marine and hydrokinetic renewable energy

PTC in lieu of ITC Extension in 2019

Section 48 allows certain projects to elect ITC in lieu of PTC

ITCs for wind projects were provided an unexpected 1-year extension

- Projects that began construction before the end of 2016 – 30% ITC
- Projects that began construction in 2017 – 24%
- Projects that began construction in 2018 – 18%
- Projects that began construction in 2019 – 12%
- Projects that begin construction in 2020 – 18%
- Projects that begin construction after 2020 – zero

How to Qualify a Project for PTCs / ITCs

The Tax Code requires a project "begin construction" by a certain date to qualify for the applicable PTC or ITC

- Wind - The IRS issued a lineage of "Begin Construction Notices" starting with IRS Notice 2013-29 and through IRS Notice 2019-43 (the "Wind Notices")
- Solar - The IRS issued Notice 2018-59 (the "Solar Notice") regarding beginning construction of solar projects
  - The Solar Notice largely follows the Wind Notices

Start project construction by the deadline either with:

- Physical Work Test – "Physical work" of a "significant nature" on property that is "integral" to the project's energy generating equipment must "start" by the deadline

  Or

- 5% Safe Harbor - The taxpayer must "pay" or "incur" "at least 5%" of the "eligible project costs" by the deadline

Physical Work Test

- "Physical work" of a "significant nature" on property that is "integral" to the project's energy generating equipment must "start" by the deadline

- Both onsite work and offsite work can qualify as physical work integral to the project
  - But, offsite physical work does not count
    - if it is on property normally held in inventory by the vendor or
    - if the work begins, or payment is made, before a "binding written contract" is entered into by the parties

- Physical work means manufacturing, constructing, assembling, excavating

Physical Work Test – What is Significant

- "Physical work" of a "significant nature" on property that is "integral" to the project's generating equipment must "start" by the deadline

  - Work is of a significant nature if it is qualitatively significant. The test focuses on the "<u>nature of the work performed, not the amount or the cost</u>"
  - There is no dollar minimum in the guidance. There may be a dollar minimum imposed by investors
  - There is no requirement that the physical work be of any minimum amount (technically). Goes to the nature of the work completed before the deadline
    - Supporting documentation could become important. Manufacturing logs, IE reports/certificates and pictures might be a requirement of investors
    - Investors may also look at the amount of man-hours spent to get comfortable

- Work must be on property that is "integral" to the project's generating equipment
  - Only work that is on the generating equipment or work necessary for the generating equipment to function counts

Physical Work Test – IRS Examples of Significant Work

- The IRS Guidance provides a "non-exclusive" lists of onsite and offsite work that it views as being work of a "significant nature"
- **Wind Notices**
- Onsite "significant" work includes (1) "excavation for the foundations", "setting of anchor bolts" or "pouring of concrete pads of the foundations". (2) work on operation and maintenance roads (not access or visitor parking roads) and (3) buildings/structures that are essentially an item of equipment or a building/structure integral to the energy property and that cannot be economically used for another purpose
- Offsite "significant" work includes "physical work on a custom designed transformer". Must be manufactured under a binding contract and not in inventory
- **Solar Notice**
- Onsite "significant" work includes (1) "installation of racks or other structures" to affix panels, collectors or solar cells, (2) work on operation and maintenance roads (not access or visitor parking roads) and (3) buildings/structures that are essentially an item of equipment or a building/structure integral to the energy property and that cannot be economically used for another purpose
- Offsite "significant" work includes manufacturing of components, mounting equipment, support structures, racks, rails, inverters and custom designed step up transformers. These components must be manufactured under a binding contract and not in inventory

Physical Work Test – Work that Does Not Count

Work that <u>does not</u> count towards "physical work" of a "significant nature" on property that is "integral" to the project

- Work on transmission assets does not count
- The IRS says fencing does not count
- Physical work does not mean "preliminary activities" such as design, planning, studies, securing financing, getting permits, performing tests on the land or resource, clearing the site, contouring land or removing old foundations

Physical Work Test – Start Construction

- "Physical work" of a "significant nature" on property that is "integral" to the project's solar generating equipment must "start" by the deadline

- There is no requirement that the work continue on once it starts, as long as the project is finished by the end of the fourth year after construction started (continuity test safe harbor)
  - If you start work on a transformer, for example, by the deadline and the work stops for one or more years, that is not a problem as long as the project is placed in service by the deadline under the continuity test
  - If it is not placed in service by that deadline, the project owner will have to prove physical work was continuous, which may be difficult, as a general rule

5% Safe Harbor

- The taxpayer must "pay" or "incur" "at least 5%" of the "eligible project costs" by the deadline
  - Cash basis taxpayers have to pay at least 5% by the deadline
  - Accrual basis taxpayers have to incur at least 5% by the deadline
  - "Pay" – actual cash out the door. Not a payment made with money loaned to the buyer by the seller of equipment
    - Just getting an invoice is not a payment
    - Refundable deposit is not payment
  - "Accrual" – All events have occurred that fix the amount and make it due (perhaps with the passage of time) AND economic performance has occurred
    - Economic performance occurs when the item is delivered, title passes or the item is accepted, with one major exception
      - If the taxpayer pays for the equipment by the deadline and reasonably expects delivery, title or acceptance within 3.5 months of the payment date, the payment date can count as economic performance occurring
      - IRS Notice 2020-41 provides a safe harbor for costs paid or incurred on or after September 16, 2019, in that the 3.5 month rule is deemed satisfied if the property or services are received by the taxpayer no later than October 15, 2020

5% Safe Harbor – Calculation of 5%

- The taxpayer must "pay" or "incur" "at least 5%" of the "eligible project costs" by the deadline

  - The test looks to at least 5% of the aggregated cost of the project . If you are at 4.99%, you haven't met the test
  - As with the physical work test, project costs only look to costs of the generating equipment, plus other integral equipment. It does not include land costs or transmission costs (including network upgrades behind the interconnect). It does include "soft" costs related to the costs of equipment, such as legal expenses relating to the purchase of equipment
  - The IRS permits a project to be broken down into units. If the actual costs incurred are more than expected, the IRS has said that the taxpayer can carve units off of the project and claim the ITC or PTC on a smaller project if needed in order to meet the 5% test

5% Safe Harbor – Practical Considerations

- The taxpayer must "pay" or "incur" "at least 5%" of the "project costs" by the deadline

  - Disregarded entities do not have a method of accounting for federal tax purposes, the taxpayer is the first regarded entity in the upstream ownership chain
    - Developers or sellers of projects relying on the 5% Test should be prepared to disclose information of the ultimate regarded taxpayer to determine the appropriate method of accounting
  - May need to allocate part of the contract price to other services or equipment if the contract is for more than just a single piece or type of equipment or includes non-incidental services that have not yet been performed
  - "Binding written contract" requirements apply, but the components can be held in the manufacture's inventory for purposes of the 5% Test
  - Make sure contract is in the name of the proper taxpayer, or its disregarded entity, and that payment is made by the same party. Avoid later clean-ups
  - Consider inspections at time of delivery, pictures of equipment, bi-laterally executed acceptance documents and other documentation to support the date equipment is delivered
  - Keep good payment / invoice records

Continuity Requirement

- Once construction starts, it must be continuous until the project is placed in service, either by (i) maintaining a “continuous program of construction” (in the case of work of a physical nature), or (ii) making “continues efforts” to complete the project (in the case of utilizing the 5% safe harbor)
- The IRS provided a presumption of continuity as long as the project is finished by the end of the fourth (4th) year after the year project first starts construction
- If you are outside of the four (4) year period, you have to prove you were continuous and that will be very tough, given conservative financing parties
- IRS Notice 2020-41 extends the four (4) year continuity by one (1) year for projects that began construction in either 2016 or 2017
- In addition to the continuity requirement, solar projects must be placed in service by the end of 2023 to claim the 30%, 26% or 22% ITC rather than the reduced 10% ITC. The 4 year continuity safe harbor does not extend that deadline
- You may not switch between methods (5% one year and physical work the next year or vice versa) in order to extend the four year period

Transfers

- Project Transfers - Third Parties. Once construction starts, the project may be transferred to a third party, but such transfer must include assets other than just tangible personal property
  - The transferee "steps into the shoes" of the taxpayer that safe harbored the project
  - The transferor need not retain any interest
- Tangible Property Transfers - only to Related Parties. Safe harbored equipment can be transferred by itself, without a project or other assets, only to a "related party" (>20% of capital or profits) or transferred to another project of a developer without the requirement for inclusion of other non-tangible personal property
  - A developer that has a stockpile of grandfathered equipment may sprinkle the equipment down to various projects it owns
- The projects do not need to be pre-defined when the equipment is purchased, under the master agreement rule
- The developer may acquire a project after the deadline and incorporate its grandfathered equipment into that project

Useful Tips

- Proper documentation and corroborative support is critical
- Investors and buyers will diligence thoroughly. May have different levels of comfort or risk tolerance
- Don't assume *any* physical work satisfies the test, stick with the enumerated examples in the IRS Notices for wind and solar
- The 5% Test requires economic performance and a binding written contract. Plan for cost overruns
  - Delivery or constructive delivery by the deadline or within 3.5 months of payment (if supported by method of accounting)
- Third party work - binding contract and no work before the contract was signed
- Confirm no work started too early…could impact the date the project must achieve COD under the 4 year continuity safe harbor
- Respect the 4 year continuity safe harbor. Relying on "facts and circumstances" to show continuous efforts could be difficult, particularly if there was little activity in the few years after the project began construction

Flip Partnership

Rev. Proc. 2007-65 safe harbor structure.
Typical allocation of taxable items:

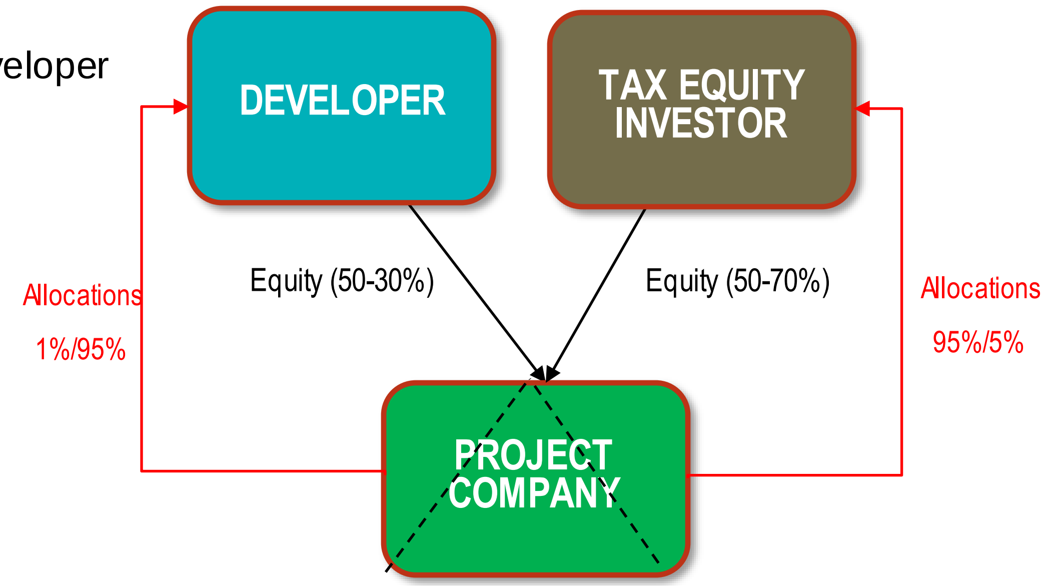
Pre-Flip:

- Tax Items - 99% - Tax Equity; 1% - Developer
- Cash distributions – varies:
  - Developer – 50%-90%
  - Tax Equity Investor - 10-50%

Post-Flip:

- Tax Items and cash distributions
  - 5% - Tax Equity
  - 95% - Developer

Flip occurs when Tax Equity has achieved an agreed ATIRR, or (less common) at a fixed time



Flip Partnership – cont'd

Tax equity investment is sized to achieve a target flip date at, or about, year 10, using a P50 case

- Current market flip rate for wind deals – 6%-7%

Tax equity funds 50%-70% of project equity

Majority of the Tax equity return is received from tax credits and tax depreciation

- Generated during the early years of the project

PAYGO limited to 25% of total Tax Equity contributions

ITC deals – varies in flip dates (e.g., after year 1, flips to 67%, with a second flip to 5% after year 5); timing of Tax Equity investment critical for credits

Flip Partnership - cont'd

Flip partnership – the good and the less so…

- Very well known and understood structure
- Provides flexibility in allocations
- Available for both PTC and ITC
- Safe harbor for wind projects
- Call option post-Flip Date at a relatively low amount (vs. leases)
- Complex partnership tax rules, modeling and legal documents
- Complicated financial accounting - HLBV

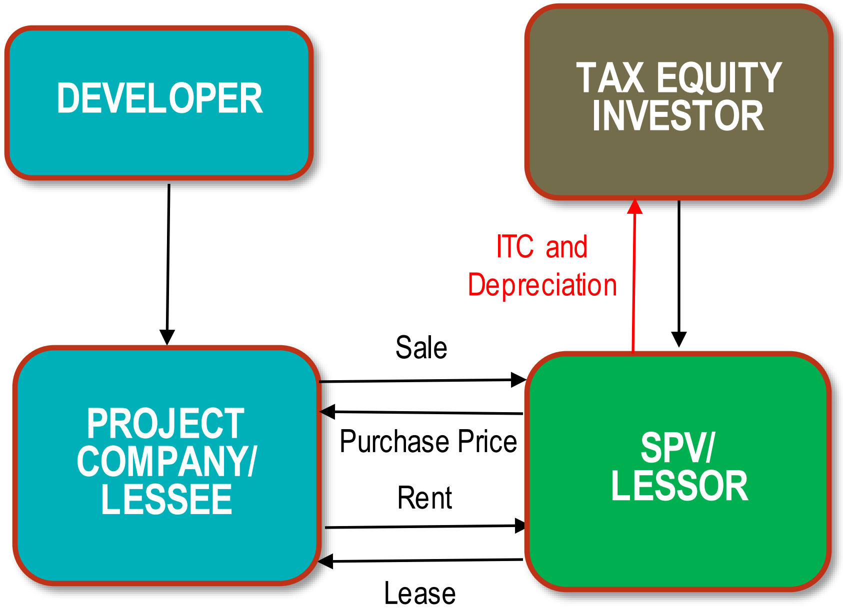
Sale-Leaseback

Tax Equity Investor, as project owner, is entitled to claim ITC and depreciation

Sale and leaseback can take place any time up to 3 months after the project is placed in service

Can only be used for ITC, not PTC (for PTC, taxpayer must both own and operate the facility)

Lessee typically has a fair market value purchase option at end of lease term



Sale-Leaseback – cont'd

Sale Leaseback – the good and the less so…

- Structure is only available for ITC, not PTC
- Lease must satisfy the "true lease" test
- Lower financing requirement from developer – Tax equity could finance 100% of the project cost; However, typically, lessee would then be required to make rent prepayments of ~10%-50%
- ITC amount based on Project FMV (higher than cost)
- Tax equity does not take development or construction risk
- Complex legal docs
- Higher exit cost - purchase option is more expensive than in partnership flip
- Developer may bear more tax risk than in a partnership flip, due to required tax indemnity obligations

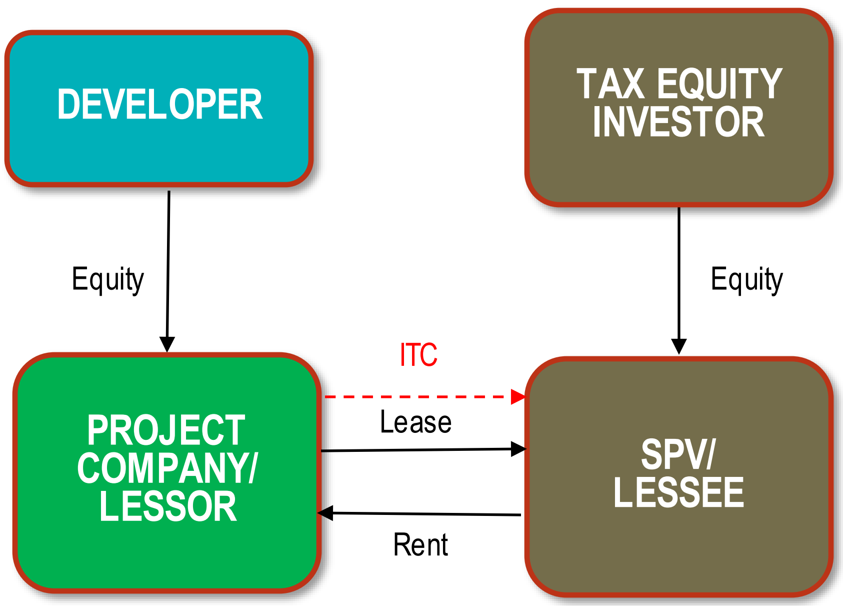
Inverted Lease – Simple Structure

Developer makes a "pass through" election which allows Tax Equity Investor to claim ITC

Developer, not Tax Equity Investor, claims depreciation

Tax Equity Investor usually contributes between 20-50% of project costs; remainder must be financed by Developer (either debt or equity)

Additional more complex variations of this structures…mainly used for resi solar



Inverted Lease – cont'd

Inverted Lease – the good and the less so…

- Structure is only available for ITC, not PTC
- Lease must satisfy the "true lease" test
- No reduction of basis due to the ITC; Tax Equity, as lessee, includes 50% of the ITC amount as income during the intial 5 year period
- Higher financing requirement from Developer - Tax equity finances only 20%-50% of project costs
- Partial monetization of tax benefits - Developer takes all (or some, in the more complex inverted lease structures) of the depreciation deductions
- Developer may bear more tax risk than in a partnership flip, due to required tax indemnity obligations
- Less common, complex structure
- No exit cost – at the end of the lease, project returns to developer without any payment

Solar ITC Tax Basis Cases

A central challenge in all solar deals is how to get a step up in tax basis so that the tax benefits are calculated on the fair market value of the project rather than its cost.

Three recent cases (*Alta Wind*, *Bishop Hill,* and *California Ridge*) have created uncertainty.

- project company sale
- developer fees
- disguised sale

The government recently moved to dismiss the *Alta Wind* case based on a novel lack of standing argument related to the sponsor indemnity.

- There is some debate in the legal community about the broader implications to sponsor indemnity provisions if the government wins the motion.

Pitfalls to Avoid and Market Trends

- 2020 vs. 2019 Beginning of Construction – 60% PTC (or 18% ITC) vs. 40% PTC (or 12% ITC)
  - Blend and extend
  - Rescission
- Continuity Requirement
  - Construction slipping into 2021
  - Corona virus delays
- Offshore wind – increased interest; continuity in excess of 4 years
- Repower transactions
- Storage technology- growing trend
- PTC/ITC insurance
- Post-election extenders bill? Battery storage and/or offshore ITC bills?

Stay tuned…