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Solar Energy and ITC: New IRS Guidance on Begin-Construction Requirement

Transferring Energy Property, Treatment of Multiple Energy Properties as Single Facility

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Solar Start of Construction Guidance

The IRS issued Notice 2018-59 on June 22, 2018 (the “IRS Guidance”).

Takeaways:

- **Guidance largely follows wind guidance.**
- **Start project construction by the deadline either with:**
 - (1) physical work of a significant nature or (2) pay at least 5% of the project costs.
- **Deadlines:**
 - Deadline to start construction is Dec. 31, 2019 for the full 30% ITC.
 - The credit dips to 26% for projects starting construction in 2020 and 22% for projects starting construction in 2021.
 - Projects meeting these deadlines must still be placed in service by the end of 2023 to qualify for a credit above 10%.
 - The credit drops to a permanent 10% level for projects that begin construction in 2022 or later.
 - Projects that begin construction before 2022, but are not placed in service until 2024 or later, are also limited to the 10% credit.

Physical Work Test

- “Physical work” of a “significant nature” on property that is “integral” to the project’s solar 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.
- Work performed by a third party must be after a “binding contract” is entered into. Elements discussed later.

Physical Work Test

- “Physical work” of a “significant nature” on property that is “integral” to the project’s solar generating equipment must “start” by the deadline.
- Physical work means manufacturing, constructing, assembling, excavating.
- 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

- “Physical work” of a “significant nature” on property that is “integral” to the project’s solar generating equipment must “start” by the deadline.
- Work is of a significant nature if it is qualitatively significant. The test focuses on the “nature of the work performed, not the amount or the cost.”
- 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.
- **Work must be on property that is “integral” to the project’s solar generating equipment.**
 - Only work that is on the generating equipment or work necessary for the generating equipment to function counts.

Physical Work Test

- The IRS Guidance provides a “non-exclusive” lists of onsite and offsite work that it views as being work of a “significant nature”:
- 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.
 - Practically, the IRS Guidance provides solar projects with a definitive onsite physical work safe harbor for (1) installation of racks and (2) construction of operational roadways.
- 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.
 - Practically, it may be difficult to ensure that a manufacturer does not keep racks, rails, inverters or other components in its inventory unless those components are “custom designed” for the solar project.

Physical Work Test

- Work that does not 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.
- The IRS confirmed informally that the reference to 69 kV in the guidance was meant to say if power is stepped up from generation voltage to transmission voltage, a second step-up transformer to a higher voltage does not count. It is viewed as a transmission asset.

Physical Work Test

- “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 is impossible, as a general rule.

5% Test

- The taxpayer must “pay” or “incur” “at least 5%” of the “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.
- “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.

5% Test

- Continued...
- 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 solar 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-incidentals services that have not yet been performed.
 - “Binding written contract” requirements apply, but the components can be held in the manufacturer'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-up matters among related parties or upstream owners.
 - Consider inspections at time of deliver, pictures of equipment, bi-laterally executed acceptance documents and other documentation to support the date equipment is delivered.
 - Keep good payment records.

5% Test

- The taxpayer must “pay” or “incur” “at least 5%” of the “project costs” by the deadline.
 - The test looks to at least 5% of the costs. If you are at 4.99%, you haven’t met the test.
 - 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 on a smaller project if needed in order to meet the 5% test.
 - Rooftop projects are treated as one unit, so that cost overrun protection is not available for rooftop (C&I or residential) projects.

5% Test

- The taxpayer must “pay” or “incur” “at least 5%” of the “project costs” by the deadline.
- 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 solar modules.

Binding Written Contract

- **Work performed by a third party must be done under a “binding contract.”**
 - A binding contract does not include an option agreement.
 - Must specify scope, design specifications, price and amount to be purchased/provided.
 - Must be binding under state law.
 - Must be entered into before work begins under the contract.
 - Damages cannot be limited to less than 5% of the contract price.
 - The parties cannot make substantial changes to the contract terms once work begins (does not apply to change orders for additional work or related to matters outside the parties control).
 - Cancellation terms should not allow for a full refund of the purchase price once work begins (i.e., right to terminate without damages).

Single Project

- Units of property (i.e., blocks or strings of panels) may be aggregated into a larger project for both physical work or 5% test purposes.
- They must be owned/operated as a single unit, however.
- Facts that suggest a project are owned/operated as a single unit are:
 - Single owner
 - Single offtaker
 - Single interconnection
 - Common permitting, and described as one in filings.
 - Single financing.
 - Single site.
 - Single substation.
 - Single construction contract.
- Rooftop projects must be aggregated. However, separate adjacent rooftops may not be. For example, a series of houses in a row on a residential street may not be aggregated together to be one project.

Continuity Requirement

- The general rule is that once construction starts, it must be continuous until the project is placed in service.
- No one knows that that means, so the IRS provided a presumption of continuity as long as the project is finished by the end of the fourth year after the year project first starts construction.
- If you are outside of the four year period, you have to prove you were continuous and that will be very tough, given conservative financing parties. Solar projects must be placed in service before January 1, 2024 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, unless you started construction before 2019.
- If you started construction before 2019, you can use another method to “restart” in 2019. The dates in the example in that section of the guidance are wrong. This should be one year later.

Transfers

- Once construction starts, the project may be transferred to a third party.
- If the project only consists of grandfathered equipment, then the transferor must retain at least 20.1% of capital or profits of the entity to which it transfers the equipment.
- If the project consists of other items as well, the transferor need not retain any interest.
- 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.
- The project developer may acquire a project after the deadline and incorporate its grandfathered equipment into that project.

Transfers

- **Third Party Transfers.** 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.
- **Affiliate Transfers.** Safe harbored equipment can be transferred to affiliates (at least 20.1% 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.
- The project developer may acquire a project after the deadline and incorporate its grandfathered equipment into that project.

Observations

- Proper documentation and corroborative support is critical.
- Investors and buyers will diligence thoroughly. They may not have the similar levels of comfort or risk tolerance.
- The 5% Test and meaningful onsite physical work on racks or roads is the easiest to sell to investors/lenders. Don't assume any physical work satisfies the test, stick with the enumerated examples in the IRS Guidance.
- The 5% Test requires economic performance and a binding written contract. Do not forget. Take into account possible cost overruns.
 - That means, take delivery or constructive delivery by the deadline or make full payment prior to the deadline and take delivery within 3.5 months (but confirm your method of accounting).
- If you use third parties, be sure that your work happens under binding contracts and no work happened before the contract was signed. All subs should do work under binding contracts as well.
- Consider satisfying the 5% Test or physical work test in 2019, to avoid any confusion that construction might have begun in 2018 or earlier. Could impact the date your solar project must achieve COD under the 4 year continuity safe harbor.