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IRS Releases New Guidance Regarding the "Beginning of Construction" Requirements for Energy Investment Tax Credits

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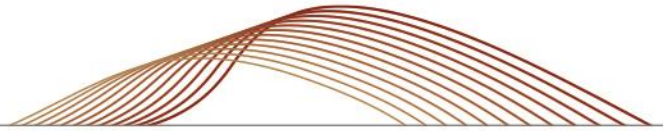
On June 22, 2018, the IRS issued Notice 2018-59 to clarify the beginning of construction requirements for both the Physical Work Test and the Safe Harbor Test (as described below) with respect to the extension of energy investment tax credits ("ITCs") under Section 48 of the Internal Revenue Code of 1986, as amended (the "Code") by the Bipartisan Budget Act of 2018 (the "BBA"). The notice also established a continuity requirement and a continuity safe harbor.

On December 18, 2015, the Consolidated Appropriations Act ("CAA") extended and modified the ITC for solar energy property for which construction began after December 31, 2019, but before January 1, 2022, and limited the amount of the ITC available for solar energy property that is not placed in service before January 1, 2024. The BBA changed the placement in service requirement under prior law to a requirement that the construction of energy property must begin before January 1, 2022 so that the effect was to retroactively extend ITC rates in excess of 10% by five years for fiber-optic solar, qualified fuel cell, qualified microturbine, combined heat and power system, qualified small wind, and geothermal heat pump property which begins construction before January 1, 2022. The BBA also phased out the ITC for fiber-optic solar, qualified fuel cell, and qualified small wind energy property over five years so that projects related to these energy properties must be placed in service before January 1, 2024.

Guidance in Prior Notices

Under Notices 2013-29 and 2013-60, the IRS provided that a taxpayer would be eligible to qualify for renewable electricity production tax credits ("PTCs") under Section 45 of the Code and ITCs that a taxpayer elects to take in lieu of PTCs if, among other things, construction on the facility began before January 1, 2014. Notice 2013-29 stated that the beginning of construction requirement could be satisfied either (i) by making a significant beginning of physical work (the "Physical Work Test") or (ii) after the facility has been placed into service, by showing that at least five percent of the total cost of the facility had been incurred or paid before January 1, 2014 (the "Safe Harbor Test"). The relevant Code and notice provisions also required that for purposes of satisfying either the Physical Work Test or the Safe Harbor Test, the taxpayer must also have made continuous progress toward completing the project after construction began (the "Continuity Requirement"). Notice 2013-60 provided that this Continuity Requirement would be considered satisfied if the facility was placed into service before January 1, 2016 (the "Continuity Safe Harbor"). In that notice, the IRS and the Treasury Department



also indicated that the transfer of a facility by an owner or developer after construction begins would not necessarily bar the facility from qualifying for an ITC or PTC. Notice 2014-46 clarified the manner in which both the Physical Work Test and the transfer of a facility after the beginning of construction would affect a taxpayer's eligibility for ITCs and PTCs. That notice also lowered the Safe Harbor Test from five percent to three percent in certain circumstances. After an extension of the ITC and the PTC by the Tax Increase Prevention Act of 2014, the IRS and the Treasury Department issued Notice 2015-25 which extended the Continuity Safe Harbor if a taxpayer began construction on a facility prior to January 1, 2015, and placed the facility in service before January 1, 2017, regardless of the amount of physical work performed or the amount of costs paid or incurred with respect to the facility after December 31, 2014 and before January 1, 2017.

With respect to the Continuity Safe Harbor, Notice 2016-31 further extended and modified it and provided additional guidance regarding its application in the context of qualified facilities which take the PTCs under Code Section 45 or elect to take the ITCs under Code Section 48. In addition, this notice provided guidance regarding the Physical Work Test and clarified the application of the Safe Harbor Test to retrofitted qualified facilities.

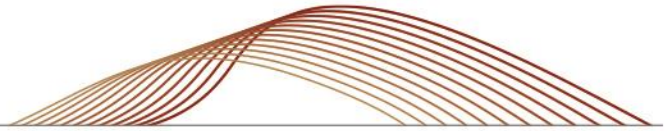
Under the new BBA rule that focuses on the beginning of construction prior to January 1, 2022, with respect to ITC eligible facilities, Notice 2018-59 provides guidance to determine when construction has begun. Similar to prior ITC and PTC guidance, Notice 2018-59 provides two methods to establish the beginning of construction, a physical work test and five percent safe harbor, to establish the beginning of construction, a continuity requirement for each method, rules for transferring energy property, and additional rules applicable to the beginning of construction requirement under Code Section 48.

Physical Work Test

A project can meet the beginning of construction requirement when physical work of a significant nature begins. The Physical Work Test does not consider the amount of work or its cost but only focuses on the nature of the work performed. Notice 2018-59 provides that both off-site and on-site work can be used to determine the beginning of construction. Off-site work includes, but is not limited to, activities such as manufacturing components and mounting equipment. On-site work includes, but is not limited to, activities such as installation of racks or other structures to affix solar cells to a site for solar energy property and installation of components of a fuel cell stack assembly such as gasketing or plates for qualified fuel cell property. Physical work that constitutes a preliminary activity, such as planning, designing, or researching, and physical work that produces components of energy property that are held in inventory do not qualify for the Physical Work Test.

Safe Harbor Test

A project can also meet the beginning of construction requirement when the taxpayer pays or incurs five percent or more of the total cost of the energy property. The Safe Harbor Test includes the depreciable basis of energy property in the total cost, which does not include the cost of land or any property not integral to the energy property. The Safe Harbor Test is not met if the total cost of an energy property for a single project that is made up of multiple energy properties exceeds its anticipated total cost so that the amount a taxpayer paid or incurred ends up being less than five percent of the total cost of the single project at the time it is placed in service. However, the Safe Harbor Test will be satisfied and ITCs may be claimed with respect to some of the energy properties that make up the single project as long as the total aggregate cost of those energy properties is not an amount that is more than 20 times greater than such amount paid or incurred. The Safe Harbor Test will not be satisfied if the total cost of a single energy property, which is not part of a single



project and cannot be separated into multiple energy properties, exceeds its anticipated total cost so that the amount the taxpayer paid or incurred is less than five percent of the total cost of the single energy property at the time it is placed in service. In that case, the Safe Harbor Test will not be met for any portion of the single energy property.

Continuity Requirement

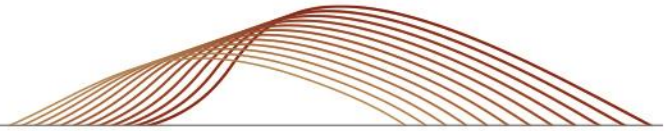
Both the Physical Work Test and the Safe Harbor Test have continuous efforts requirements that must be met for the beginning of construction. The continuity requirement for both tests will be determined under relevant facts and circumstances, but continuous efforts to complete an energy property may include, but are not limited to: paying or incurring additional amounts included in the total cost of the energy property, entering into a binding written contract for the manufacture, construction, or production of components of property or for future work to construct the energy property, and obtaining necessary permits. The continuity requirement for both tests can still be met even if there are certain disruptions. Notice 2018-59 lists excusable disruptions which include, but are not limited to, delays due to severe weather conditions, natural disasters, and labor stoppages. The timing for an excusable disruption must be determined in the calendar year during which the energy property is placed in service (or the calendar year the last energy property is placed in service for multiple energy properties). The continuity requirement will be deemed met if an energy property is placed in service no more than four calendar years after the calendar year during which construction began.

Transfer of Energy Property

Under Code Section 48(a)(3)(B), energy property may be constructed, reconstructed, or erected by the taxpayer or may be acquired by the taxpayer if the original use of such property begins with the taxpayer. A taxpayer can claim the ITC with respect to energy property even if the taxpayer did not own such energy property at the time construction began as long as the taxpayer owns such energy property on the date it is originally placed in service. Therefore, a fully or partially developed energy property may be transferred for purposes of the ITC without losing its beginning of construction qualification under the Physical Work Test or the Safe Harbor Test. A taxpayer may also claim the ITC with respect to energy property if the property is transferred to a different site and placed in service. The work performed or the costs paid or incurred prior to the transfer will still qualify to meet the Physical Work Test or the Safe Harbor Test. However, if such tangible personal property is transferred to an unrelated party without any further development activity, the work performed or the costs paid or incurred prior to the transfer will not be taken into account for either test.

Additional Beginning of Construction Rules

For purposes of determining whether construction has begun for purposes of the ITC, multiple energy properties that are operated as part of a single project (along with any components of property) will be treated as a single energy property. The determination for a single energy property will depend on the relevant facts and circumstances, which may include, but are not limited to, the energy properties being owned by a single legal entity, having a common intertie, and sharing a common substation. This determination will be made in the calendar year during which the last of the multiple energy properties is placed in service. Multiple energy properties that are operated as part of a single project for determining whether construction has begun may be disaggregated and treated as multiple separate energy properties for purposes of determining whether a separate energy property satisfies the Continuity Safe Harbor.



For both the Physical Work Test and the Safe Harbor Test, the physical work or the costs paid or incurred must be for property that is integral to the production of electricity but does not include property used for the transmission of electricity. The construction of roads can be integral to an energy property, including onsite roads that are used for equipment to operate and maintain the energy property; however, roads that are primarily for access to the site or used for employee or visitor vehicles are not integral to the activity performed by an energy property and will not be included in the Physical Work Test or the Safe Harbor Test. Fencing and buildings are not considered integral parts of energy property; however, buildings do not include a structure that is essentially an item of machinery or equipment or a structure that houses property that is integral to the activity of energy property where the use of the structure is so closely related to the use of the housed energy property that the structure can clearly be expected to be replaced when the energy property it houses is replaced.

For both the Physical Work Test and the Safe Harbor Test, the taxpayer can include construction done by binding written contract by another person if the work performed and amounts paid or incurred under the contract are taken into account when construction begins. The binding written contract must be entered into prior to the work being performed or the costs being paid or incurred. A written contract is considered binding only if it is enforceable under local law against the taxpayer or a predecessor and does not limit damages to a specified amount. A taxpayer may also enter into a binding written contract for several components of property to be manufactured, constructed, or produced for the taxpayer by another person and assign its rights to certain components to an affiliated special purpose vehicle. Under this situation, the work performed or amounts paid or incurred with respect to the original contract may be taken into account to determine when construction of the energy property begins. Notice 2018-59 also has a look-through rule where both on-site and off-site work (whether performed by the taxpayer or by another person pursuant to a binding written contract) may be taken into account to meet the Physical Work Test. For the Safe Harbor Test, energy property with components produced by another person pursuant to a binding written contract will include the costs paid or incurred by the other person before the energy property is provided to the taxpayer when the amounts are paid or incurred by the other person.

Energy property may contain used components of property, provided that the fair market value of the used components does not exceed twenty percent (20%) of the energy property's total value. This rule is applied to each energy property that comprises a single project if a single project is made up of multiple energy properties. For purposes of the Physical Work Test and the Safe Harbor Test, only work performed on, or amounts paid or incurred for, new components of property used to retrofit used components of property or an existing energy property may be counted.

Overall, Notice 2018-59 clarifies the beginning of construction requirements for both the Physical Work Test and the Safe Harbor Test with respect to the extension of ITCs by the BBA. Notice 2018-59 also provides a continuous efforts requirement and safe harbor with a list of excusable disruptions. It also allows for transfers of energy property where previous development activity can count toward meeting the Physical Work Test or the Safe Harbor Test. Additional guidance is also provided to determine whether multiple energy properties which comprise a single project meet the Safe Harbor Test and the continuity safe harbor; whether costs are integral to the production of electricity; whether work performed under a binding written contract qualifies for the Physical Work Test or the Safe Harbor Test; and to what extent used components of property can qualify for either test.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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