Published on *The National Law Review* https://natlawreview.com

IRS Issues New Guidance on Beginning Construction Requirement For ITC

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The IRS recently issued Notice 2018-59 (the "Notice") which provides clarification to "beginning of construction" for taxpayers seeking to take advantage of the section 48 renewable electricity investment tax credit (ITC) for solar and other renewable energy facilities including qualified fuel cell, combined heat and power, qualified small wind and geothermal heat pump. The Notice largely follows the "begun construction" guidance that the IRS has previously issued for energy facilities that qualify for the production tax credit (PTC), discussed in our blog post here ("Notice 2016-31"), and the follow up guidance that clarifies the beginning construction safe harbor for those facilities, discussed in our blog post here ("Notice 2017-4").

Here, as in Notice 2016-31 and Notice 2017-4, taxpayers have two ways to establish start of construction. They can either show that they (i) began physical construction of a significant nature (the "Physical Work Test"), or (ii) incurred at least 5% of the total cost of the eligible facility (the "5% Safe Harbor"). The Physical Work Test does not consider the amount of work or its cost but only focuses on the nature of the work performed being significant. Both off-site (including the manufacture of components, mounting equipment, and support structures) and on-site work (including the installation of racks and other structures to affix PV panels, collectors, or solar cells) may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. However, 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. Once construction has begun or costs have been paid or incurred, taxpayers must make continuous progress towards completion to satisfy both the Physical Work Test and the 5% Safe Harbor ("Continuous Construction Requirement").

The Notice provides a safe harbor for satisfying the Continuous Construction test (the "Continuity Safe Harbor"). The Continuity Safe Harbor is met if the facility is placed in service by the end of the calendar year that is no more than four calendar years after the calendar year in which construction of the facility began. For example, if construction begins on an energy property on January 15, 2018, and the energy property is placed in service by December 31, 2022, the energy property will be considered to satisfy the Continuity Safe Harbor.

The Notice states that although a taxpayer may satisfy both methods of establishing the beginning of construction, construction will be deemed to have begun on the date the taxpayer first satisfies one of the two methods discussed above. As an example, the Notice provides that if a taxpayer performs physical work of a significant nature on energy property in 2018, and then pays or incurs 5% or more of the total cost of the energy property in 2019, construction will be deemed to begin in 2018 under the Physical Work Test, not in 2019 under the 5% Safe Harbor. Thus, the Continuity Safe Harbor will be applied beginning in 2018, not in 2019.

As in prior Notices, multiple energy properties that are operated as part of a single project (along with any components of property that serve some or all of the properties) will be treated as a single energy property for purposes of determining whether construction has begun. Whether multiple energy properties are operated as part of a single project will depend on the relevant facts and circumstances. Multiple energy properties that are operated as part of a single project and treated as a single energy property for purposes of determining whether construction of an energy property has begun may be disaggregated and treated as multiple separate energy properties for purposes of determining whether each separate energy property satisfies the Continuity Safe Harbor.

Finally, the notice provides for repowering of a facility. Under the Notice, energy property may qualify as originally placed in service although it contains some used components of property, provided the fair market value of the used components is not more than 20% of the energy property's total value (the "80/20 Rule"). In the case of a single project comprised of multiple energy properties, the 80/20 Rule is applied to each energy property comprising the single project. For purposes of the 80/20 Rule, the cost of a new energy property includes all properly capitalized costs of the new energy property.

National Law Review, Volume VIII, Number 188