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The Clean Energy Revolution: Renewable Energy Tax Incentives and Issues

by Michael Q. Cannon

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In this article, Cannon explores the issues that tax advisers must master to help their clients successfully participate in the clean energy revolution.

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One of the significant pillars of President Biden's presidential platform was his "Plan to Build a Modern, Sustainable Infrastructure and an Equitable Clean Energy Future."[1] As part of that platform, he recognized the key role that tax incentives have played in accelerating renewable growth, and promised to take steps to that would further "reform and extend" these incentives to "unleash a clean energy revolution in America . . . and spur the installation of millions of solar panels . . . and tens of thousands of wind turbines — including thousands of turbines off our coasts."[2]

In light of Biden's plan to build on the current incentive regime, existing investors in the clean energy sector may seek to expand their footprints. There also may be new investors seeking to enter this sector. These investors (and their tax advisers), along with sponsors (who are often referred to as developers), must master a host of complicated tax rules and avoid pitfalls that can jeopardize the financial viability of (or seriously impair the available returns from) investments in renewable energy projects. While we still don't know, of course, whether Biden's plans will be successful or what legislation will ultimately be enacted, if any, it seems clear that fostering renewable energy development will remain a significant policy focus for the foreseeable future. Tax advisers who understand the current tax incentives will be best positioned to advise clients with an interest in entering into renewables transactions and being part of the "clean energy revolution." To that end, this article provides a high-level discussion of some of the key tax-related issues and considerations that potential investors in, and sponsors of, renewables projects need to be aware of, with a focus on utility-scale wind and solar projects.

Available U.S. Federal Income Tax Incentives — Background Basics

In addition to 100 percent expensing (which is an incentive that is available for some renewable energy projects, but is more broadly applicable than the renewable energy incentives that are the focus of this article), the key U.S. federal income

[1] JoeBiden.com, The Biden Plan to Build a Modern, Sustainable Infrastructure and an Equitable Clean Energy Future.

[2] *Id.*

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tax incentives available for wind projects are the production tax credit (PTC) under section 45 and the investment tax credit under section 48, and the key incentive available for solar projects is the ITC.

A taxpayer that produces electricity at a "qualified facility" from a "qualified energy resource" during the "10-year period beginning on the date the facility was originally placed in service" is, in general, entitled to a PTC equal to 1.5 cents per kilowatt hour, as adjusted for inflation,[3] in the year that the electricity is sold to an "unrelated person."[4] Wind is a qualified energy resource.[5] A facility using wind to produce electricity is a qualified facility if that facility was originally placed in service after December 31, 1993, and if construction of that facility "began before January 1, 2022."[6]

As to ITC, to the extent a taxpayer places in service "energy property" meeting specific requirements, the taxpayer is generally entitled to claim ITC equal to the applicable "energy percentage" of the basis of such energy property.[7] "Energy property" under section 48 includes both specific wind and solar generation assets.[8] The tax basis of the energy property must be reduced by 50 percent of the energy ITC claimed, leaving the remainder of the basis to be recovered through depreciation deductions (including, when available, 100 percent expensing).[9] If ITC is claimed for wind energy property, that property is not eligible for PTCs.[10]

As anyone who has provided tax advice on transactions involving these credits is well aware, qualifying for these credits (and monetizing them) does not just happen — it requires careful planning by tax advisers and faithful implementation of that planning by transaction participants. This article discusses a few of the key issues and pitfalls that sponsors of and investors in wind and solar projects must confront. Before presenting that discussion, the article provides some high-level background regarding a few of the structures commonly used by sponsors to finance wind and solar projects.

Common Renewable Energy Transaction Structures

Some large strategic sponsors of wind and solar projects simply construct (financing the construction using borrowed money or balance sheet financing) and hold the project, using the tax benefits generated by the project. Many sponsors, however, do not have enough tax appetite to fully monetize the tax benefits generated by the renewable energy projects they develop.[11] These sponsors have several alternatives, including developing the project and then selling it to a strategic investor that does have sufficient tax capacity or partnering with an investor (generally a large U.S. corporate investor) in a tax equity financing transaction. A tax equity financing transaction allows a sponsor that lacks sufficient taxable income to effectively monetize tax benefits generated by a project. This type of arrangement lets a sponsor use its core capabilities of developing, managing, and operating renewable energy projects without

[3] The current rate is 2.5 cents per kilowatt hour. Notice 2020-38, 2020-23 IRB 903.

[4] Section 45(a). The amount of the credit is subject to potential phaseout under section 45(b)(1) if the reference price of electricity for that year exceeds 8 cents, as adjusted for inflation. The amount of the credit is also subject to reduction if any of the following occur: (1) "grants [are] provided by the United States, a State, or a political subdivision of a State for use in connection with the project," (2) "proceeds of an issue of State or local government obligations [are] used to provide financing for the project the interest on which is exempt from tax under section 103," (3) "subsidized energy financing [is] provided (directly or indirectly) under a Federal, State, or local program . . . in connection with the project," or (4) "any other [tax] credit allowable [is received] with respect to any property which is part of the project." Section 45(b)(3). The limitation on receiving credits applies only to federal, not state, credits. *See* Rev. Rul. 2006-9, 2006-1 C.B. 519. Relatedness is defined in section 45(e)(4). Section 4 of IRS Notice 2008-60, 2008-30 IRB 178, further clarifies the "related party" power sales rules.

[5] Section 45(c)(1)(A).

[6] Section 45(d)(1).

[7] Section 48(a).

[8] Solar "energy property" that is ITC eligible includes property (A) that is "equipment which uses solar energy to generate electricity . . . excepting property used to generate energy for the purposes of heating a swimming pool" or that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight; (B) the construction, reconstruction, or erection of which is completed by the taxpayer or which is acquired by the taxpayer if the original use of such property commences with the taxpayer; (C) for which depreciation is allowable; and (D) that meets the performance and quality standards (if any) that have been prescribed in regulations and are in effect at the time of the acquisition of the property. Section 48(a)(3)(A)-(D).

[9] Section 50(c)(3).

[10] A taxpayer who wants to claim ITC for wind energy property must irrevocably elect to claim ITC in lieu of PTCs. Section 48(a)(5)(A).

[11] Both the PTC and the ITC are nonrefundable tax credits, meaning that they only benefit investors who have sufficient taxable income to use the credits. The term "tax appetite" is sometimes used to refer to the ability to effectively use renewable energy tax incentives.

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sacrificing the economic benefits of the tax incentives available regarding those projects.

While there are several potential variations, the most common tax equity structures generally employ a partnership (usually a limited liability company classified as a partnership for U.S. federal income tax purposes) between the sponsor and one or more tax equity investors (such partnership entity, the tax equity partnership). The tax equity investor makes an investment in the tax equity partnership (either by making a capital contribution to the tax equity partnership or by purchasing an interest in the tax equity partnership from the sponsor[12]) and is allocated a disproportionate share of the tax benefits (including PTCs and ITCs) generated by that partnership. A substantial portion of the tax equity investor's return (which is measured on an after-tax basis) comes in the form of economic benefits realized by such tax equity investor through the allocation of tax credits to the tax equity investor from the tax equity partnership.

The most common tax equity partnership structure, one that is uniformly used in PTC deals and is often used in ITC deals, is the so-called flip partnership structure, whereby the tax equity investor receives disproportionate allocations (for example, in a PTC deal, generally 99 percent) until the investor realizes a target internal rate of return (based on cash flow plus defined tax benefits), after which the investor's percentage interest "flips" to a residual interest (for example, in a PTC deal, generally 5 percent).[13] Another potential tax equity partnership structure, one that is employed only in ITC deals and is less common than the flip partnership structure, is the inverted lease. In inverted lease structures, the tax equity investor generally invests in a tax equity partnership that leases the project from a master landlord entity formed by the sponsor. The tax equity partnership claims the ITC under a special rule (discussed in more detail later in this article) permitting the master landlord to pass ITC through to the tenant. The master landlord retains ownership and is entitled to claim depreciation regarding the project, although sometimes the tax equity partnership owns part of the master landlord (itself a partnership) and is accordingly entitled to a portion of the depreciation (which can, in turn, be allocated to the tax equity investor).[14]

Key Issues and Pitfalls

Begun Construction Issues

Eligibility for both the PTC and the ITC (and the magnitude of the PTC or ITC available) depends in part on when construction of a project begins.[15] The relevant provisions of the Internal Revenue Code have not been static over recent years, but the tables below summarize the current state of the "begun construction" rules from a timing perspective. The first table summarizes the begun construction timing requirements for wind projects seeking to qualify for PTCs or ITCs. The second summarizes the timing requirements for solar projects seeking to qualify for ITCs. The remainder of this section then explains how a sponsor or developer can begin construction under relevant guidance, highlighting that the rules are more complicated than they might appear at first glance.

[12]Whether the tax equity investor acquires its interests by making a contribution or through an equity purchase generally turns on tax structuring considerations relevant to claiming bonus depreciation/100 percent expensing. These considerations are outside the scope of this article.

[13]The percentages in this sentence are allocation percentages. Cash distribution provisions can (and often do) vary substantially from these percentages. Yield-based flip structures like the one described in the text are the most common type of partnership flip structure; another variation is a fixed flip structure, under which the "flip" point happens at a defined point in time (*e.g.*, after year 5) whether or not tax equity has received its target return. The IRS has provided an allocation safe harbor for wind PTC deals, which is of critical importance to the structuring of tax equity partnerships. *See* Rev. Proc. 2007-65. Because the focus of this article is on qualifying for the ITC and PTC, discussion of this safe harbor is outside the scope of this article. It is worth adding that there is no analogous safe harbor for solar ITC deals, but the IRS has, in internal analysis, considered aspects of the wind allocation safe harbor in analyzing a solar transaction, despite concluding that a taxpayer is not permitted to use the wind safe harbor before the IRS as support for a solar transaction (and the structure of such a solar transaction). *See* CCA 201524024.

[14]Another potential tax equity structure that does not involve a tax equity partnership is a sale-leaseback arrangement, whereby the developer sells a project to a tax equity investor, which leases the project back to the developer. Sale-leaseback structures are less common than partnership flip structures and inverted leases, but do have some advantages, including the ability for a tax equity investor to claim ITC for a project that was placed in service before the sale-leaseback transaction and the ability for a sponsor to transfer 100 percent of the tax credits and depreciation to a tax equity investor.

[15]As discussed under the next subheading, the date on which a project is placed in service is also relevant.

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Table 1. Wind Projects

Year When Construction Started	PTC Availability (as a percentage of maximum statutory rate)[a]	ITC Availability (as a percentage of basis)[b]
2016 (or earlier)	100%	30%
2017	80%	24%
2018	60%	18%
2019	40%	12%
2020	60%	18%
2021	60%	18%
2022	0%	0%

[a]Section 45(b)(5).

[b]Section 48(a)(5)(E). Special rules for "qualified offshore wind facilities" permit ITCs for offshore wind facilities to be claimed at the 30 percent rate as long as construction of the projects begins before Jan. 1, 2026. Section 48(a)(5)(F). While PTCs (rather than ITCs) are the incentive of choice for onshore wind projects, offshore wind projects are relatively more expensive to construct, so sponsors of offshore wind projects generally plan to qualify those projects for the ITC.

Table 2. Solar Projects

Year When Construction Started	ITC Availability (as a percentage of basis)
2019 (or earlier)	30%
2020	26%
2021	26%
2022	26%
2023	22%
2024 (or later)	10%

The IRC does not specify what constitutes beginning construction, but the IRS has provided some guidance in a series of notices.[16] At a high level, there are two available methods for establishing that construction has properly begun — the "physical work" method and the 5 percent safe harbor method.[17] Potential developers of renewable energy projects must take great care to make sure that each project has appropriate and well-documented begun construction facts. Having these well-documented facts is even more important if a developer anticipates selling a project or bringing in a tax equity investor, because potential purchasers and tax equity investors will carefully scrutinize the begun construction narrative for a project when determining whether to invest (and on what terms).[18] The relevant begun construction rules are highly nuanced, with a number of pitfalls for the unwary, some of which are described below.

Under the "physical work" test, a taxpayer establishes that construction has begun by "starting physical work of a significant nature" before the applicable begun construction deadline on the qualified facility or energy property used to produce electricity.[19] Whether "physical work of a significant nature" has begun is determined based upon all the "relevant facts and circumstances."[20] Both "work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract that is entered into prior to the manufacture, construction, or production" of the property "for use by the taxpayer in the taxpayer's trade or business (or for the taxpayer's production of income) is taken into account in determining whether construction has begun."[21] If the "work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold required to satisfy" the

[16]For wind projects, the key notices are IRS Notice 2013-29, 2013-20 IRB 1085; IRS Notice 2013-60, 2013-44 IRB 431; IRS Notice 2014-46, 2014-35 IRB 520; IRS Notice 2015-25, 2015-13 IRB 814; IRS Notice 2016-31, 2016-23 IRB 1025; IRS Notice 2017-4, 2017-4 IRB 541; IRS Notice 2019-43, 2019-31 IRB 487; IRS Notice 2020-41, 2020-25 IRB 954; and IRS Notice 2021-5, 2021-3 IRB 479. For solar projects, the key notices are IRS Notice 2018-59, 2018-28 IRB 196; IRS Notice 2019-43; IRS Notice 2020-41; and IRS Notice 2021-5.

[17]*See generally* IRS Notice 2013-29 and IRS Notice 2018-59.

[18]If a tax equity investor perceives weakness or gaps in the begun construction narrative, the tax equity investor is more likely to seek a legal representation from the sponsor that the begun construction requirement is satisfied (backstopped by an indemnity from a creditworthy party) or to demand that a PTC/ITC tax insurance policy be put in place regarding begun construction matters and the qualification of the facility for PTCs or ITCs, as applicable.

[19]*See* IRS Notice 2013-29, section 3; and IRS Notice 2018-59, section 3. The date on which a qualified facility is placed in service is also relevant. This is discussed below under the "Construction Progress and Placed in Service Issues" heading.

[20]*See* IRS Notice 2013-29, section 4; and IRS Notice 2018-59, section 4.

[21]IRS Notice 2013-29, section 4; and IRS Notice 2018-59, section 4.

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physical work test.[22] A "binding written contract" is one "entered into prior to the work taking place" that is "enforceable under local law against the taxpayer or a predecessor" and does not limit damages to a specified amount that is less than 5 percent of the total contract price.[23] If a developer of a particular project is hoping to establish begun construction through work performed by a third party under a contract, the developer's tax advisers must carefully scrutinize that agreement to make sure it qualifies as a binding written contract because provisions that might seem beneficial to a developer from a commercial perspective (such as a provision permitting termination for convenience) can cause a contract to fail to qualify as a binding written contract.

Both on-site (for example, excavation of turbine foundations for a wind project) and off-site work may be taken into account in determining whether physical work of a significant nature has begun.[24] However, only work on "tangible property used as an integral part of the activity performed by the" applicable energy facility will be considered for purposes of determining whether a taxpayer has begun construction.[25] This property includes "property integral to the production of electricity."[26] Thus, for example, physical work on "a custom-designed transformer that steps up the voltage of electricity produced" at the applicable facility "to the voltage needed for transmission" counts for purposes of determining whether physical work on a facility has commenced, "because power conditioning equipment is an integral part of the activity performed by the facility."[27] Well-advised developers seeking to bring in tax equity investors or to sell a project will carefully document the begun construction work that was done, including by obtaining certifications from the applicable supplier and third-party documentary support (frequently, this documentary support will include a report (including date-stamped photographs) from an independent engineering firm documenting a visit to a project site or factory where off-site work has taken place).

Under the other method for establishing begun construction, the 5 percent safe harbor, a taxpayer establishes that construction has begun by incurring (within the meaning of reg. sections 1.461-1(a)(1) and (2)) 5 percent or more of the "total cost" of the facility by the applicable begun construction deadline.[28] Only costs that are "properly included in the depreciable basis" of the facility are appropriately taken into account for purposes of determining whether a taxpayer has begun construction.[29] Because the qualifying costs will, by definition, be incurred early on in a project's development, to guard against the possibility that costs may be higher than expected, developers seeking to use the 5 percent method should build in a buffer (for example, incurring costs equal to 6 to 7 percent of the anticipated depreciable basis of the facility).

It is worth clarifying that in determining whether construction of a project has begun, the general rule is that multiple facilities "that are operated as part of a single project . . . will be treated as a single" facility.[30] Thus, and assuming that multiple facilities are treated as a single facility, it is not necessary that physical work begin on each facility (for example, each wind turbine) forming part of a single project under the physical work method, and it is similarly not

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[22] IRS Notice 2016-31, section 5; and IRS Notice 2018-59, section 4; *see also* IRS Notice 2014-46, section 3 (noting that the relevant "test focuses on the nature of the work performed, not the amount or cost").

[23] IRS Notice 2013-29, section 4.03; and IRS Notice 2018-59, section 7.03.

[24] IRS Notice 2013-29, section 4.02; and IRS Notice 2018-29, section 4.02.

[25] IRS Notice 2013-29, section 4.05; and IRS Notice 2018-59, section 7.02.

[26] *Id.*

[27] Notice 2013-29, section 4.05; and IRS Notice 2018-59, section 7.02(1). Using off-site physical work on a step-up transformer (being constructed under a binding written contract) is a relatively common strategy employed to establish that construction of a project has begun.

[28] IRS Notice 2013-29, section 5; and IRS Notice 2018-59, sections 3, 5. Importantly, costs incurred by an accrual-basis taxpayer may be treated as incurred on the date when the taxpayer makes payment (even if that payment precedes the date on which the goods for which the payment is made are delivered), as long as the taxpayer reasonably expects that such property will be provided within 3½ months of payment and consistently applies the 3½-month rule. Reg. section 1.461-4(d)(6)(ii). In practice, developers frequently rely on the 3½-month rule. Developers seeking to rely on it should, as a matter of best practice, ensure that they take delivery within 3½ months of the date when payment is made (and that delivery is well documented). It is worth noting that in response to the COVID-19 pandemic, IRS Notice 2020-41 made some taxpayer-friendly modifications to the 3½-month rule regarding services or property paid for on or after Sept. 16, 2019. IRS Notice 2020-41, section 4.

[29] IRS Notice 2013-29, section 5.01(1); and IRS Notice 2018-59, section 5.02.

[30] IRS Notice 2013-29, section 4.04(2); and IRS Notice 2018-59, section 7.01(2).

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necessary that 5 percent of the cost of each facility or energy property be incurred under the 5 percent safe harbor method as long as 5 percent of the total project costs are incurred by the required date.[31]

Once construction of a project has properly begun, a developer must make sure that later developments do not jeopardize the project's status as a project that has begun construction. In addition to the continuity-of-work requirements discussed in the next subsection, the unrelated-party transfer rules (sometimes referred to as the anti-trafficking rules) can serve as a trap for the unwary. In general, a fully or partially developed facility may be transferred without losing its status as a project whose construction has begun. However, the anti-trafficking rule provides that if a "transfer consist[s] solely of tangible personal property . . . to a transferee not related" (defined for these purposes by section 197(f)(9)(C)[32]) "to the transferor, any work performed or amount paid or incurred by the transferor with respect to" the transferred property "will not be taken into account with respect to the transferee for purposes of" determining whether the physical work test or 5 percent safe harbor test has been satisfied.[33] To avoid running afoul of these rules, developers must make sure that no transfer of the ITC/PTC qualifying equipment (that is, a transfer solely of tangible personal property) occurs between parties that are not appropriately related at the time of such transfer.

Construction Progress and Placed-in-Service Issues

Properly beginning construction on a project on time (consistent with the requirements described under the preceding subheading), although necessary, is insufficient to qualify a project for PTCs or ITCs.

The begun construction safe harbor for PTC qualification also demands that progress toward completion be made after construction begins, which is often referred to as the "continuity" requirement.[34] The IRS has provided a safe harbor for this requirement. If construction on a project began (for example, through "starting physical work of a significant nature") in 2016 or 2017, then the project will be deemed to satisfy the element if the project is placed in service for federal income tax purposes by the later of (a) December 31, 2018, and (b) the end of the calendar year that is no more than five calendar years after the calendar year during which construction began.[35] Thus, if construction of a wind project began in 2016 (or is deemed to have begun in 2016) and such project is placed in service on or before December 31, 2021 (the end of the fifth year after construction began), such project will be considered to satisfy the "continuous program of construction" requirement.[36] When a project seeking to qualify for PTCs is not placed in service by the safe harbor date, a taxpayer can still seek to demonstrate that

[31] The IRS notices specify a nonexclusive list of factors indicating that multiple facilities are operated as part of the same project. These include, but are not limited to, whether: (a) the facilities are owned by a single legal entity; (b) the facilities are constructed on contiguous pieces of land; (c) the facilities are described in a common power purchase agreement or agreements; (d) the facilities have a common intertie; (e) the facilities share a common substation; (f) the facilities are described in one or more common environmental or other regulatory permits; (g) the facilities were constructed under a single master construction contract; and (h) the construction of the facilities was financed under the same loan agreement. IRS Notice 2013-29, section 4.04(2); and IRS Notice 2018-59, section 7.01(2).

[32] The relatedness threshold under section 197(f)(9)(C) is more than 20 percent. For example, a partner is related to a partnership if the partner maintains more than a 20 percent capital interest in that partnership or more than a 20 percent profits interest in that partnership.

[33] IRS Notice 2014-46, section 4.03; and IRS Notice 2018-59, section 8.

[34] Under the physical work test, the requirement is for maintenance of a "continuous program of construction." IRS Notice 2014-46, section 3; IRS Notice 2013-60, section 3; and IRS Notice 2013-29, section 3. Under the 5 percent safe harbor method, the requirement is for the taxpayer to make "continuous efforts" toward completion. IRS Notice 2013-29, section 5. It is interesting that the continuity requirement for PTC qualification is not explicitly provided for in the code, which merely demands that construction begin by a particular date to qualify for PTCs. Notwithstanding this fact, tax equity transactions are generally structured to comply with the guidance in the IRS notices.

[35] For a useful discussion of the placed-in-service rules that apply to renewable power facilities, see Sean Moran et al., "Renewable Power Facilities: Placed-in-Service Issues," *Tax Notes*, May 23, 2016, p. 1109.

[36] Notice 2020-41, section 3; Notice 2017-4, section 3; and Notice 2014-46, section 2. For construction that began during other years (that is, not in 2016-2017), the safe harbor demands that the project be placed in service no later than four years after the year in which construction began. The special rule for 2016 and 2017 start-date projects was issued in response to the COVID-19 pandemic. IRS Notice 2020-41. Also, IRS Notice 2019-43 provides some special rules that toll and extend the continuity safe harbor by up to four years in respect of development delays resulting from pursuing a modification to a plan to mitigate significant national security concerns raised by the Defense Department. There are also special rules that meaningfully extend the safe harbor for qualified offshore wind projects and federal land projects. IRS Notice 2021-5.

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the project satisfies the continuity requirement under a general all "relevant facts and circumstances" test.[37]

The date when a facility seeking to qualify for ITC is placed in service is also critical.[38] Unlike the PTC, which has no statutory placed-in-service deadline, regarding solar ITC property, the code provides that to qualify for ITC at a greater than 10 percent rate, the relevant property must be placed in service no later than December 31, 2025.[39] In addition to this statutory deadline, the IRS has articulated both a continuity requirement and continuous construction safe harbor for solar ITC projects.[40] This requirement (and safe harbor) operates similarly to the PTC rules described in the preceding paragraph. In particular, the safe harbor applies as long as a project is placed in service no later than the end of the fourth year after construction began.[41] If a project does not meet the continuity safe harbor, then (like the PTC safe harbor) a facts and circumstances test applies to determine whether the continuity requirement is satisfied. For projects relying on the physical work test, the continuity requirement demands continuing physical work of a significant nature.[42] And for projects seeking to qualify under the 5 percent safe harbor, the continuity requirement demands continuous efforts to advance toward completion.[43] Like the guidance on projects seeking to qualify for PTCs, the ITC guidance provides a list of disruptions that are excusable.[44]

Because the placed-in-service requirements are detailed and complicated, tax advisers to developers or tax equity investors need to make sure they have a good grasp of these rules.

Ownership-Related ITC Limitations (Including Tax-Exempt Use Property)

Various types of property are not eligible for ITCs.[45] Among the most significant of these limitations are those set forth in section 50(b), which provides (in relevant part) that ITCs are not available for the following: (1) property used predominantly outside the United States, (2) property used by certain tax-exempt organizations (unless that property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511, as unrelated business taxable income), including property held by partnerships with one

[37] The relevant IRS notices specify that, regarding the "physical work" test, a "continuous program of construction involves continuing physical work of a significant nature" and further specify a list of "excusable" disruptions (which include things such as severe weather conditions, licensing and permitting delays, and so forth). *See* IRS Notice 2013-29, section 4.06. Regarding the 5 percent safe harbor (and the "continuous efforts" requirement), the safe harbor both specifies some facts and circumstances that are indicative of continuous efforts to advance toward completion (including items such as paying or incurring costs related to the facility, obtaining necessary permits, and so forth) and specifies a list of disruptions that will not be considered as indicating that a taxpayer has failed to make continuous efforts toward completion. *See* IRS Notice 2013-29, section 5.02(1). Several tax advisers (including the author) think the continuous efforts standard (regarding the 5 percent safe harbor) is easier to satisfy than the "continuous construction" requirement (regarding the physical work test).

[38] In the context of a tax equity partnership transaction, it is worth noting that apart from determining ITC availability as a general matter, the timing of the tax equity investor's investment in the tax equity partnership must be carefully coordinated to make sure that the timing of the investor's admission does not jeopardize its ability to claim the ITC (as the ITC generally arises when a project is placed in service). A two-stage funding is a commonly used mechanism to address this issue.

[39] Code section 48(a)(6)(B). As noted previously, special ITC qualification rules apply for qualified offshore wind facilities. Under these rules (which, as noted previously, extend the begun construction deadline to December 31, 2025), there is no statutory placed-in-service deadline.

[40] IRS Notice 2018-59, section 6.

[41] IRS Notice 2018-59, section 6.05. As with wind projects, the IRS has extended the continuity safe harbor deadline to the fifth year after construction began for projects whose construction began in 2016 or 2017. IRS Notice 2020-41.

[42] IRS Notice 2018-59, section 6.01.

[43] Notice 2018-59, section 6.02. The safe harbor articulates facts and circumstances that tend to demonstrate continuous efforts, including: (a) incurring costs that will be included in the total cost of the energy property; (b) entering into binding written contracts for the manufacture, construction, or production of components or future work on energy property; (c) obtaining necessary permits; and (d) performing physical work of a significant nature. *Id.*

[44] Notice 2018-59, section 6.03 (noting delays caused by severe weather conditions, labor stoppages, and so forth) are excusable.

[45] The tax-exempt use property rules are most important in a deal in which ITC will be claimed, but the rules are also relevant in PTC deals, because property that is treated as tax-exempt use property is ineligible for bonus depreciation or the modified accelerated cost recovery system. This article provides only a brief introduction to the tax-exempt use property rules. For a more detailed discussion, see Michael Cannon, "The 100 Percent Tax-Exempt Use Property Trap: Funds Beware," *Tax Notes*, Sept. 3, 2018, p. 1403.

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or more partners that are tax-exempt organizations,[46] and (3) property used by governmental units or foreign persons or entities, including specific property held through partnerships with one or more partners that are governmental units or foreign persons or entities.[47]

While most of the limitations described in the preceding paragraph that can cause ITC disallowance if specific types of investors own an interest in "energy property" are not implicated when those owners hold their interest through a U.S.-domiciled entity classified as a taxable C corporation, there is an exception (and ITC will be disallowed in respect of property owned, directly or indirectly, by the corporation) if such corporation is a "tax-exempt controlled entity." A tax-exempt controlled entity is any corporation (other than a corporation that itself is a tax-exempt entity) if 50 percent or more (in value) of the stock of the corporation is held by one or more tax-exempt entities (other than foreign persons or entities), unless the corporation makes a special election (which has some adverse consequences for its tax-exempt owners).[48]

Potential sponsors of renewable energy projects (particularly sponsors that are investment funds) need to be sensitive to the application of the tax-exempt use property rules and cognizant of planning opportunities to avoid them.[49] And tax equity investors need to be mindful of the rules to make sure that ITCs they are expecting to receive are not reduced as a result of unanticipated application of the rules.[50]

ITC Recapture Rules

Although qualifying for the ITC as an initial matter is important, the relevant ITC rules also include "recapture rules" that apply if any energy property for which ITC has been claimed is disposed of by the taxpayer during the five-year period after such taxpayer places that property in service or otherwise ceases to be ITC-eligible property regarding the taxpayer.[51]

The ITC recapture rules can be implicated in several instances, some of which are obvious and others less so. The first, which is the most straightforward, applies when the ITC property is actually sold or disposed of during the recapture period. Tax equity partnership agreements should prohibit any sale of the property that would cause recapture.

Another circumstance that can implicate the recapture rules is when an interest in the tax equity partnership is transferred or disposed of after ITC is claimed by one of the partners. The IRC does not provide explicit guidance on how the recapture rule is to be applied in the context of a partnership that places in service ITC property and then has one of its partners dispose of its interest in the partnership. However, the regulations under former section 47 do address the issue.[52] In particular, reg. section 1.47-6(a)(2) discusses the ITC recapture implications of a partner transferring its interest in a partnership after (a) that partnership has placed in service ITC property and (b) that partner has claimed a portion of the ITC generated by such property.

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[46] In particular, property held by a partnership that has both tax-exempt and nonexempt partners is tax-exempt use property to the extent of the tax-exempt partner's "proportionate share" of that property unless all partnership allocations to the tax-exempt entity are "qualified allocations" (that is, allocations that both have substantial economic effect and do not vary over the life of the partnership) or predominantly all income allocated to the partner by the partnership is UBTI. For purposes of applying this rule, a tax-exempt entity's proportionate share of property is the highest share of income/gain that the exempt entity may receive while it is a partner. *See* section 168(h)(6)(A)-(D). The "qualified allocation" rule can be particularly problematic in the context of tax equity deals, because (as explained previously), many of these deals flip partnerships (where allocations vary over time).

[47] There is an exception, similar to the UBTI exception, for income of a foreign person that is effectively connected with the conduct of a U.S. trade or business.

[48] *See* section 50(b)(4)(D) (incorporating the rules of IRC section 168(h)(6) for purposes of determining ITC qualification); and section 168(h)(6)(F) (setting forth the tax-exempt controlled entity rules but providing for a special cleansing election that a corporation that would otherwise be a tax-exempt controlled entity can make).

[49] For a discussion of some of these planning opportunities, see Cannon, *supra* note 45.

[50] Sponsors and tax equity investors also need to be mindful of the rules in section 50(d), including the "public utility property" rule, which can further limit the availability of ITCs. For a good introduction of the public utility property rules, see David K. Burton, "PLR Allows Utility to Buy Power From Own Tax Equity Partnership," *Tax Notes Federal*, Mar. 30, 2020, p. 2063.

[51] Section 50(a).

[52] Although the investment credit recapture rules were redesignated by the Revenue Reconciliation Act of 1990, P.L. 101-508, from section 47 to section 50(a), the regulations promulgated under former section 47 have not been re-designated or reissued under section 50. Nevertheless, the regulations under section 47 on partnership property are widely considered to have retained their applicability under section 50, and in non-precedential letter rulings the IRS has treated them that way. *See, e.g.*, LTR 200837032 (stating the regulations under former section 47 "are still effective").

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Reg. section 1.47-6(a)(2) provides that on the date of such sale, the ITC-eligible property ceases to be ITC-eligible property "with respect to such partner." In other words, the portion of a partnership-generated ITC subject to recapture if a partner disposes of its interest in that partnership is generally only that partner's portion of the ITC, not the portion of the ITC claimed by the other partners.[53] That rule generally means that when a sponsor transfers its interest in a tax equity partnership, this should not subject ITC claimed by the tax equity investor to recapture. That general principle, however, is subject to an exception (which can serve as a trap for the unwary). In particular, if the sponsor transfers to a new owner whose ownership causes a portion of the property in the project to become ineligible for ITC (including as a result of it being tax-exempt use property), ITC recapture can be triggered. As a result, the LLC agreements for tax equity partnerships generally restrict transfers that would cause tax-exempt use property issues, frequently requiring that a sponsor provide a tax opinion to the tax equity investor (establishing that the transfer will not cause tax-exempt use property issues) before a transfer is permitted.

Another non-obvious circumstance that can result in recapture is when a partner who has claimed ITC retains its interest in a tax equity partnership, but its interest is reduced (either by admission of a new partner, under the terms of the partnership agreement, and so forth) by more than one-third. So, for example, if ITC was claimed by a tax equity partnership at a time when a partner's interest in general profits was 60 percent, and that partner's interest in profits was reduced to 30 percent during the recapture period, there would be ITC recapture because the percentage had been reduced by 50 percent. Thus, in a tax equity partnership, it is critical that the tax equity investor's percentage interest in the tax equity partnership not be reduced by more than one-third during the recapture period.[54]

In sum, sponsors and tax equity investors must be aware that ITC recapture rules exist and that these rules can come into play in non-obvious circumstances. If sponsors and tax equity investors fail to do so, the tax attributes that a tax equity investor is expecting to receive may be unavailable.

ITC Passthrough Election

Although the general rule is that the owner of ITC-eligible property is entitled to claim the ITC, a special election is available that permits a lessee to claim it instead.[55] This special election (referred to as a passthrough election) is employed in inverted lease transactions.[56] When a passthrough election is made, rather than the ITC being claimed based on the cost of the eligible property (that is, tax basis), the ITC is claimed based on the then-fair market value of the eligible property.[57] Tax advisers advising on solar ITC transactions that use the passthrough election must understand how the election works and make sure that it is properly made.

Re-powering

The fact that a particularly renewable energy project was previously placed in service does not foreclose the project from being reborn again as a re-powered project (eligible either for a new, 10-year PTC period or for ITC).

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[53] Making partner-by-partner recapture determinations is consistent with the partner-by-partner allocation of ITC-eligible property under reg. section 1.46-3(f), which provides that in "the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share of the basis of partnership new [ITC] property . . . placed in service by the partnership during such taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new [investment tax credit] property." Although the rules of reg. section 1.46-3(f) have also not been updated to reflect changes to section 46, these rules are explicitly referenced in the rules set forth in reg. section 1.47-6 (which, as noted, have been applied by the IRS in the context of applying section 50).

[54] Reg. section 1.47-6(a)(2).

[55] Section 50(d); reg. section 1.48-4.

[56] *See* discussion of inverted lease transaction, *supra* at Section II.

[57] Reg. section 1.46-4(c). For this reason, along with the fact that there is no IRS safe harbor for inverted leases, many tax equity investors generally view inverted lease structures as relatively more risky than "traditional" partnership flip structures. As a result, in inverted lease transactions, tax equity investors are relatively more likely to seek representations to the effect that the transaction structure will be respected (including respecting the lease as a lease for tax purposes and respecting the separateness of the master landlord and master tenant notwithstanding a specific amount of common ownership) and that the project has been appropriately valued for purposes of determining the available amount of ITC. These representations are generally backstopped by sponsor indemnification obligations.

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However, for a re-powered project to qualify, it must meet specific requirements, including (most notably) the 80/20 rule.[58] Under this rule, a facility qualifies as newly placed in service even though it contains some used property if the FMV of the used property is not more than 20 percent of the facility's total value (that is, the cost of the new property plus the FMV of the used property).[59] When a particular project comprises multiple facilities or energy properties (for example, multiple turbines for a wind farm), the 80/20 rule is applied on a facility-by-facility or energy-property-by-energy-property basis.[60]

Moreover, application of the general begun construction rules is modified slightly in the context of a re-powered project. For example, in applying the 5 percent test, only expenditures paid or incurred that relate to *new* construction are taken into account in determining whether the 5 percent safe harbor is satisfied.[61] Thus, the taxpayer does not have to newly pay or incur 5 percent of the total project value.

Tax advisers to both developers and tax equity investors contemplating development of or participation in a re-powered project must be vigilant in helping their clients understand the special rules for re-powered projects to make sure these rules are satisfied.[62]

Conclusion

The PTC and ITC are potentially powerful incentives for wind and solar investments, but unlocking that potential requires careful compliance with a host of complicated tax rules, including navigation around pitfalls that can jeopardize qualification even after a project is initially placed in service. Tax advisers must master these rules to appropriately advise participants in renewable energy transactions. Moreover, there is a good chance that those advisers who have a good mastery (or at least a basic understanding) of the current rules will also be well positioned to help advise on whatever "reform[ed] and extend[ed]" incentive regime is ultimately put in place as part of the clean energy revolution.[63] ■

[58] IRS Notice 2016-31, section 6; and IRS Notice 2018-59, section 7.05.

[59] IRS Notice 2016-31, section 6; and IRS Notice 2018-59, section 7.05.

[60] IRS Notice 2016-31, section 6; and IRS Notice 2018-59, section 7.05.

[61] IRS Notice 2016-31, section 6.02; and IRS Notice 2018-59, section 7.05(2). For example, if an existing wind project has 11 turbines (each of which has an FMV of $1 million), and if the taxpayer replaces old components (worth $900,000 per turbine) with new components costing $1.4 million per turbine (meaning that the total expenditure to retrofit the 11 turbines is $15.4 million (that is, $1.4 million * 11)), then the taxpayer must pay or incur at least $770,000 (that is, 5 percent of $15.4 million) for the 11 repowered turbines to potentially be PTC eligible. (Note the taxpayer does not have to newly pay or incur 5 percent of the total project value.)

[62] To minimize risk, in repowering transactions the tax equity investor generally requires an appraisal (as a part of an 80/20 study), and a bring-down of that appraisal on the funding date. Sponsors are generally required to represent that the FMV of the used property incorporated into each wind turbine does not exceed the amount permitted by the 80/20 rule.

[63] *Supra* note 1.

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