



## IRS Issues 30 Percent ITC Preservation Guidance

CHAD DURDEN, CPA, NOVOGRADAC & COMPANY LLP

The IRS recently issued Notice 2018-59, which provides long-awaited guidance and a safe harbor for purposes of determining when solar and certain other energy projects are deemed to have commenced construction.

This guidance pertains to Section 48 property that qualifies for the investment tax credit (ITC).

In February, the Bipartisan Budget Act of 2018 was passed containing language that replaced the placed-in service deadline that previously existed with a “beginning of construction” deadline as the gateway to qualifying for the ITC. The Consolidated Appropriations Act of 2016 established a phase down for the ITC that begins Jan. 1, 2020. Therefore, in terms of determining whether a particular renewable energy project qualifies for the ITC and the tax credit percentage that is applicable, the date that the project is determined to have commenced construction has become very important.

According to the new IRS guidance, there are two methods to demonstrate that construction has commenced on your project. The two methods are:

1. Physical work test.
2. 5 percent safe harbor.

### Continuity Requirement

Under either method, the taxpayer must demonstrate continuous progress toward completion of the project after construction has started. This is called the continuity requirement.

The continuity requirement is deemed to be met if the energy property is placed in service by the end of the fourth calendar year after the calendar year in which construction commenced. This is called the continuity safe harbor. In order for a solar developer to preserve the 30 percent ITC for their project, they need to commence construction before Jan. 1, 2020, and place it in service before Jan. 1, 2024.

### Physical Work Test

The physical work test is satisfied by performing physical work of a significant nature. The emphasis here is on physical work. This test focuses on the nature of the work much more than the amount of work performed. Physical work of a significant

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nature may include installation of racks or other structures to affix the solar panels. Both on-site and off-site work (which may be performed by another person under a binding written contract) may be taken into account.

### 5 Percent Safe Harbor

The 5 percent safe harbor test is satisfied by paying or incurring at least 5 percent of the expected total costs capitalized to the project's energy property. A taxpayer that files its tax return on the cash basis method of accounting simply needs to pay cash in order to include the cost in the 5 percent safe harbor. A taxpayer that files its tax return on the accrual basis method of accounting does not need to pay cash for the costs but must incur the costs within the meaning of Treasury Regulation 1.461-1(a)(1). In either case, the taxpayer must be provided the goods or services that it has purchased before it can consider the costs paid or incurred for federal income tax purposes.

Whether the goods or services have been provided may depend on the facts and circumstances. You cannot satisfy this test by prepaying for materials or by making a deposit for the future purchase of materials. When estimating the total cost of the energy property when completed, it is important to add in a little extra so that there is a safety net in the case of cost overruns. If the actual cost of the energy property exceeds its anticipated total cost such that the amount paid or incurred turns out to be less than 5 percent, the 5 percent safe harbor will not be fully satisfied.

### Work Performed by Contractors

Work performed by a contractor under a written binding contract may be used to satisfy the beginning-of-construction tests under certain circumstances. The example mentioned in the guidance is the manufacturing by a contractor of components such as modules, racking or inverters for a solar facility. In order for the contractor's work to qualify, the components must be manufactured specifically for

the taxpayer under the binding written contract and not held in the manufacturer's inventory. If this type of work is performed by the contractor, then their physical work may be used to satisfy the physical work test and their costs may be included to satisfy the 5 percent safe harbor. The eligibility of contractor costs is very dependent on the facts and circumstances so it is very important to consult a tax advisor who is astutely familiar with the rules.

### Be Careful to Distinguish Between Eligible and Ineligible Activities

To satisfy the tests, you must either perform physical work directly connected to the development of energy property or you must pay or incur costs that are capitalized to the energy property. Preliminary activities such as planning, permitting, engineering and securing financing are not considered physical work. So they cannot be used to satisfy the physical work test. However, the cost of preliminary activities can be used to satisfy the 5 percent safe harbor as long as they may be capitalized to the energy property. This may be a matter of accounting, but it is clear that costs incurred to secure permanent debt, organize the ownership entities, close tax credit equity, execute the power purchase agreement or purchase land are some examples of costs that are associated with assets separate from the energy property and cannot be included in the 5 percent safe harbor.

### Which Method Should I Choose?

The method that you choose to determine that your project has begun construction will depend upon many factors including the size and scope of your project and your risk tolerance for failing the test.

It may be more difficult to document the time and nature of your physical work if meticulous records are not kept. For this reason, many developers will opt for the 5 percent safe harbor, which is a more objective test and may be much easier to document. Because the 5

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percent safe harbor is an objective test, some perceive it to carry less risk of being scrutinized by the IRS.

Proving to investors and/or lenders that you meet the 5 percent safe harbor is likely going to require hiring a knowledgeable CPA. During the Section 1603 Cash Grant program, this meant hiring a CPA to issue an

agreed-upon procedures (AUP) report that included the CPA's findings on the eligible costs incurred. Novogradac & Company LLP has prepared countless 5 percent safe harbor AUP reports and we anticipate doing many more to help our clients preserve the 30 percent ITC. ❖

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**alex.ruiz@novoco.com**  
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**Christianna Cohen**  
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