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2016 Deloitte Alternative Energy Seminar

Setting new sights

November 14-16, 2016

Deloitte Center *for*
Energy Solutions



IRS
guidance
update

IRS guidance update

Recent industry guidance and guidance under development

- Begun construction—wind/other and solar
- ITC regulations update and energy storage
- IRC section 50(d) regulations
- Notice 2016-36 and gross-up payments
- Energy projects at government sites
- Revoked PLR on energy projects owned by Native American tribe

Other new developments

- Repowering wind projects/80-20 test
- Final REIT regulations

Questions and discussion

Begun construction guidance

Begun construction guidance

Notice 2016-31 (released 5/5/16; re-released 5/18/16)

- Impacts PTC and ITC in lieu of PTC (wind, biomass, hydro, geothermal, waste-to-energy)
- Extension and modification of Continuity Safe Harbor
 - Must be placed in service by the later of four years after calendar year during which BOC occurs or December 31, 2016
- Wind industry challenging retroactivity/alternating methods of BOC
 - Additional PTC guidance in development?

Solar ITC begun construction guidance

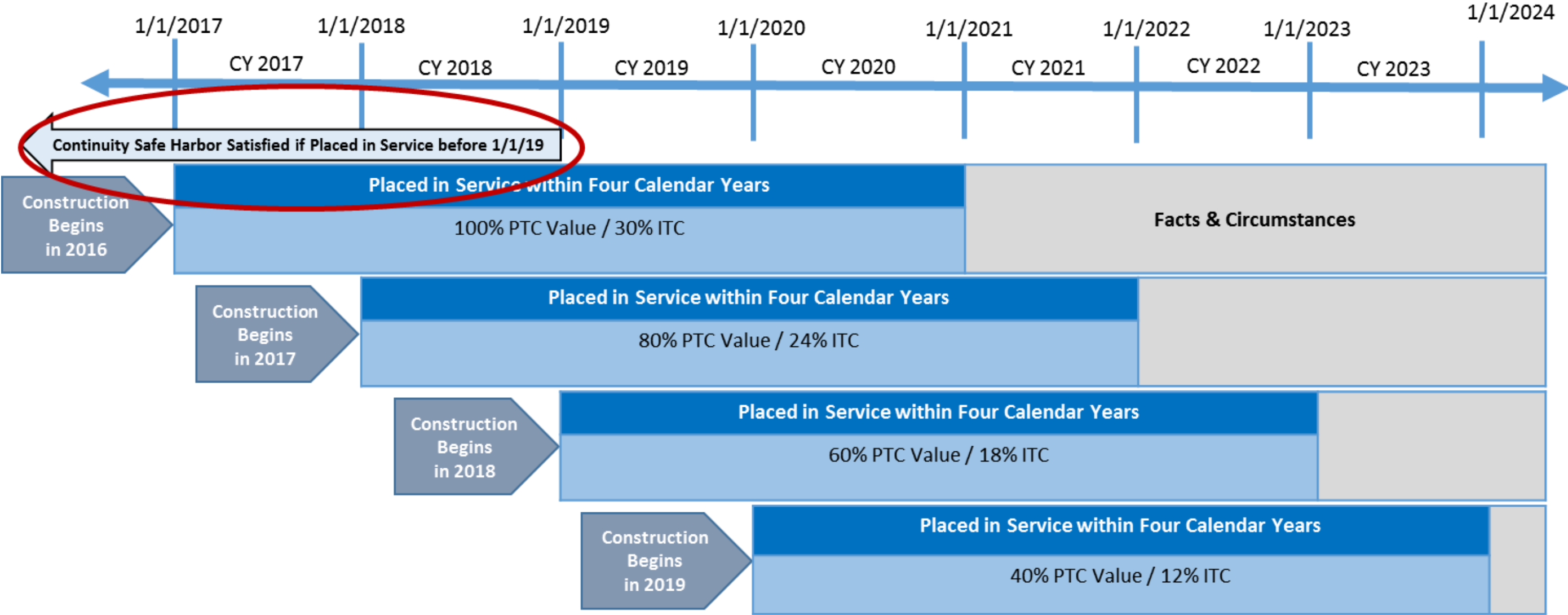
- SEIA meeting with government
- How will guidance differ from or impact PTC guidance?
- Timing?

Begun construction guidance

Recommendations for solar ITC guidance

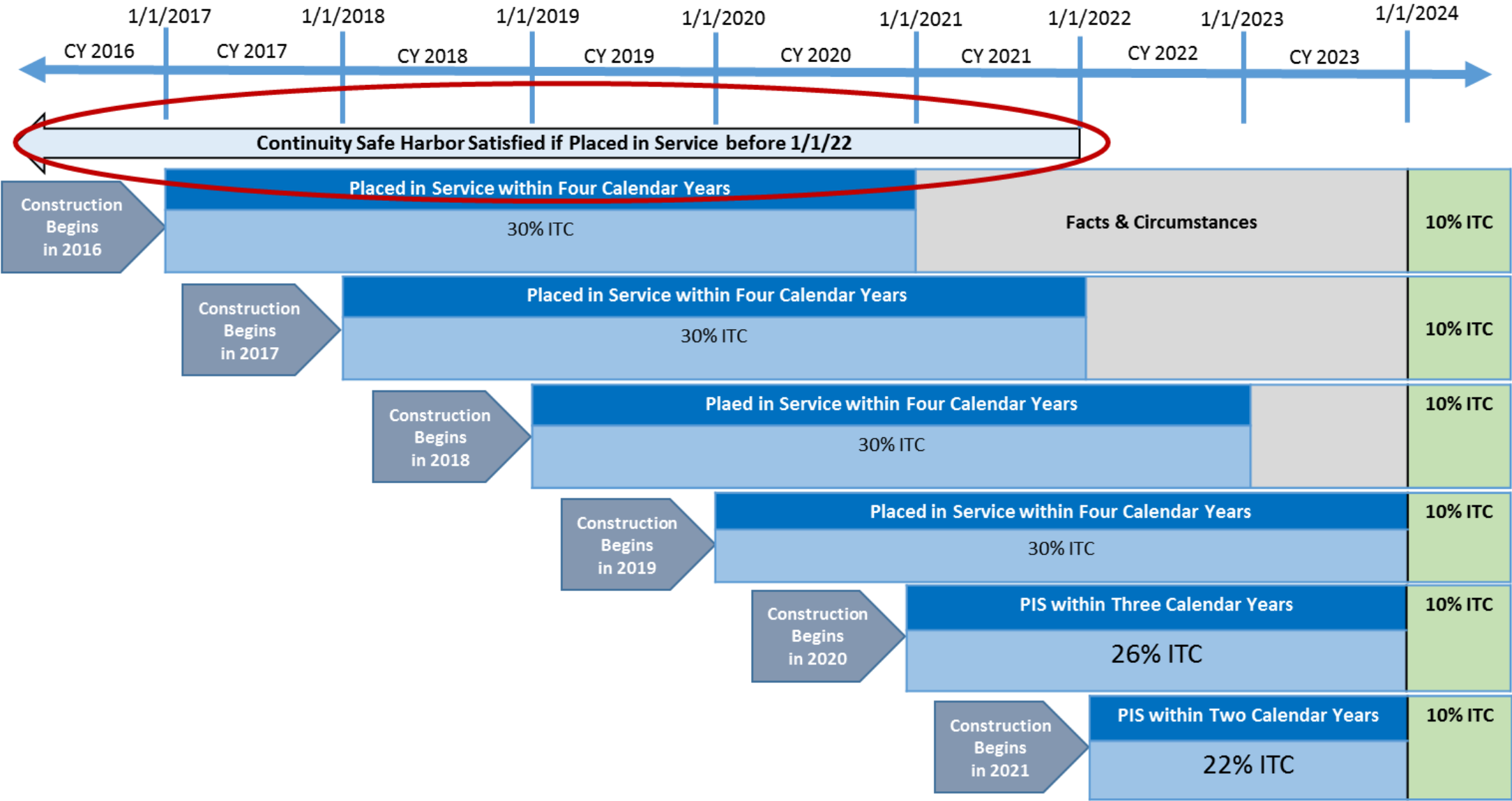
- Provide a technology-neutral Continuity Safe Harbor that aligns with the statutory placed-in-service deadline
- Confirm eligibility of property integral to the qualifying activity and provide examples
- Clarify the relevant unit of property and adopt a single project election for units of solar energy property under the ITC
- Clarify application of inventory rule
- Provide specific examples of physical work of a significant nature on solar energy property
- Adopt Five Percent Safe Harbor and incorporate a scale-back provision in recognition of cost over-runs that commonly occur in the project development process
- Clarify requirements to preserve ITC eligibility when a project or solar energy property is transferred
- Provide excusable disruptions specific to solar project development

Begun construction guidance After Notice 2016-31 with retroactive "fix"



Begun construction guidance

Assuming solar ITC guidance follows Notice 2016-31 with retroactive fix



ITC regulations update and energy storage

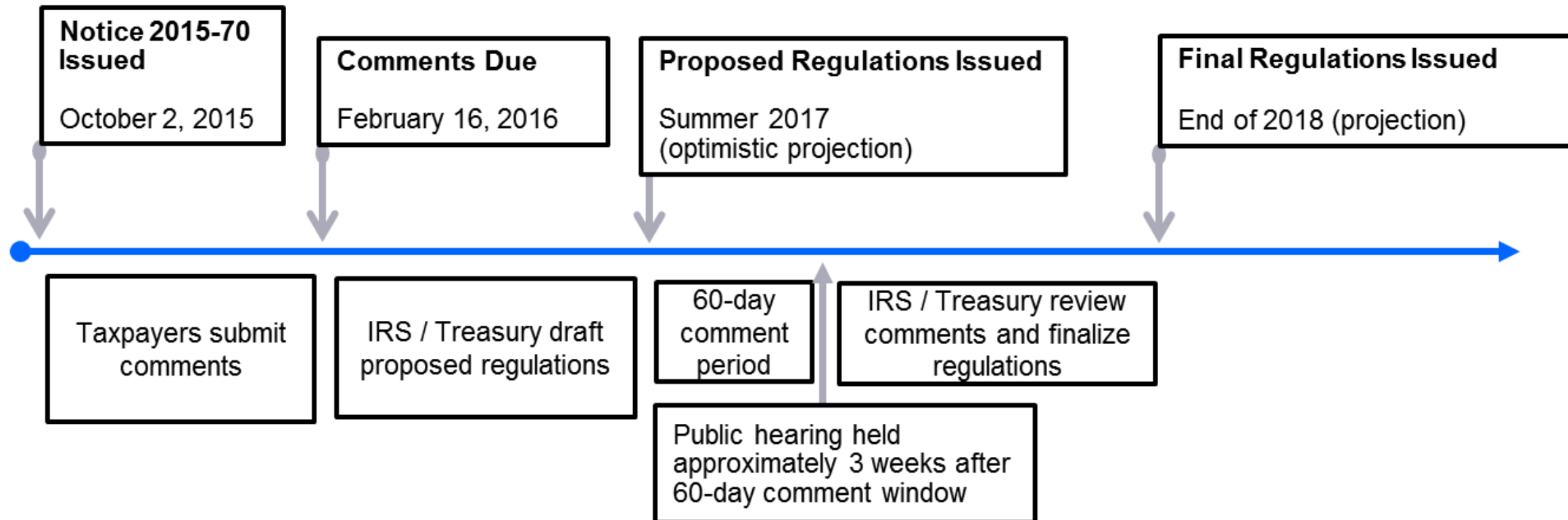
ITC regulations update and energy storage

Recurring tax technical issues

- Storage eligible? (Integral vs. functionally interdependent)
- Eligibility of storage property added to existing energy project
- Separate ownership of qualifying energy generation and storage property
- Dual use equipment rule compliance
- Drawing the box to identify relevant property
- Uncertainty around measurement methodology
- Storage as part of transmission stage? (see Treas. Reg. § 1.48-9(d)(3))

ITC regulations update and energy storage Response to Notice 2015-70

- Public comment for new regulations on definition of qualifying energy property
- 33 letters submitted
- 13 storage letters—all but one recommend more flexibility in new regulations
 - 10 letters echo letters submitted by SEIA and ESA



ITC regulations update and energy storage Industry recommendations (SEIA and ESA)

- Introduce energy storage technologies and market applications
- Emphasize regulations should re-affirm positions concerning:
 - Eligibility of energy storage device generally
 - Storage added to existing energy property
 - Separate ownership
 - Residential energy property divided between IRC sections 48 and 25D
- Proposal for application of primary use standard to dual use equipment

ITC regulations update and energy storage

Looking ahead

- IRS is producing issues memorandum for policy calls by Treasury—then drafting begins
- Options for taxpayers before new regulations?
- IRS is unlikely to consider PLR requests
- Consider documentation on the front-end of relevant eligibility issues, including:
 - Technical configurations
 - Metering for dual use equipment
 - Legal relationships of the parties
 - Do contracts really integrate solar and storage?
 - Utility contracts—control of charging/discharging?
 - Procedures to mitigate risk over recapture period

IRC section 50(d) regulations

IRC section 50(d) regulations

Inverted “pass-through lease” structure

- Treasury Department and IRS released temporary regulations and, by cross-reference, proposed regulations, concerning the income inclusion rules under section 50(d)(5) that apply to a lessee of investment credit property when a lessor of that property elects to treat the lessee as having acquired the property and thereby eligible to claim an Investment Tax Credit (ITC)—so-called inverted or pass-through lease structures
- Generally, if an owner of investment credit property claims the ITC, the owner must reduce the basis in such property by an amount of the ITC
 - 50% for energy property
- However, when a lessor of investment credit property elects to pass through the credit to a lessee under Treas. Reg. §1.48-4, the lessee is deemed as acquiring the property for fair market value
- In lieu of a basis adjustment, the lessee is required to include in gross income, over the shortest recovery period, 50% of the amount of the energy credit and 100% of the rehabilitation credit

IRC section 50(d) regulations

New regulations

- As noted in the preamble, some partnerships and S corporations have taken the position that this income is includible by the partnership or S corporation and that their partners or S corporation shareholders are entitled to increase their bases in their partnership interests or S corporation stock as a result of the income inclusion
- IRS and Treasury provide that such basis increases are “inconsistent with congressional intent,” which would “thwart the purpose of the income inclusion” and “confer an unintended benefit” that is not available to any other credit claimant
- Temporary regulations provide that any gross income required to be ratably included is not an item of partnership income for purposes of subchapter K or an item of S corporation income for purposes of subchapter S
- Each partner or S corporation shareholder that is an “ultimate credit claimant” is treated as the lessee for purposes of the income inclusion rules
- An “ultimate credit claimant” is defined as any partner or S corporation shareholder that files a Form 3468 with its income tax return
- Thus, each partner or S corporation shareholder that is an “ultimate credit claimant” must include in gross income the credit amount required under the regulations in proportion to its credit amount claimed
- The temporary regulations also provide that if after the recapture period, but prior to the expiration of the recovery period, there is a lease termination or the lessee disposes of the lease, the lessee may make an irrevocable election in such tax year to include in gross income any remaining income required to be taken into account (or if an ultimate credit claimant, in the tax year when that claimant no longer owns its entire direct or indirect interest in the lessee partnership or S corporation)

Notice 2016-36 and gross-up payments

Notice 2016-36 and gross-up payments

It has become increasingly common for utilities to charge tax gross-up payments for the cost of interconnecting renewable energy facilities to the power grid. Notice 2016-36 creates opportunity to pursue refunds of gross up payments previously made to utilities.

- Notice 2016-36 provides new safe harbor under which a transfer of property from generator to a regulated public utility will not be treated as income or as a contribution in aid of construction under IRC section 118.
- Notice 2016-36 consolidates safe harbor requirements under prior notices and removes a requirement that the generator have PPA or interconnection agreement with a utility that constructs upgrades.
- Elimination means a generator may contribute an intertie to a utility that qualifies under the new safe harbor even if the generator is interconnected with a distribution system, rather than a transmission system, if other requirements are met.
- Safe harbor also extends to transfers of interties from energy storage facilities to regulated public utilities.
- Treasury and the IRS note that these changes will promote reliability and economic efficiency throughout the grid and the development and interconnection of renewable energy resources.

Notice 2016-36 applies to transfers of interties meeting all the requirements made after June 19, 2016.

- However, taxpayers may rely on the new safe harbor for qualifying transfers made before June 20.
- The IRS will not issue private letter rulings involving the safe harbor.
- Notice 2016-36 allows utilities that recognized gross income on the transfer of property as a taxable CAIC to file a change in accounting method and exclude such amounts from income by making a corresponding basis adjustment in the transferred property.

Revoked PLR on energy projects owned by Native American tribe

Revoked PLR on energy projects owned by Native American tribe

In PLR 201640010 (issued 6/29/16; released 9/30/16), the IRS revoked prospectively PLR 201310001, concluding that a **Tribe** may not elect to pass investment credits associated with certain renewable energy assets to a lessee under IRC section 50(d)(5).

PLR 201310001 was issued 12/5/12; released 3/8/13.

- IRC concluded that an Indian tribal government is neither a governmental unit described in IRC section 50(b)(4) nor an organization exempt from tax imposed by Chapter 1 for purposes of IRC section 50. Therefore, the IRS concluded the Tribe may elect to pass investment credits associated with the energy property to a lessee in a pass-through lease structure under IRC section 50(d)(5).
- Section 50(b)(3) and (4) provides that no credit shall be determined under Subpart E with respect to property used by tax-exempt organizations and governmental units.
- Section 50(b)(3) provides that no investment credit shall be determined under Subpart E with respect to any property used by “an organization (other than a cooperative described in IRC section 521) which is exempt from the tax imposed by this chapter...” (For purposes of IRC section 50(b)(3), “this chapter” means Chapter 1, Subtitle A of the Code. Subtitle A includes the Code’s income tax provisions. Chapter 1, titled “Normal Taxes and Surtaxes” includes the income taxes discussed in Rev. Rul. 67- 284.).

Analysis and initial IRS conclusions in revoked PLR

- Rev. Rul. 67-284 holds that income tax statutes do not tax Indian tribes. Thus, an Indian tribal government is not an organization exempt from tax imposed by Chapter 1 for purposes of IRC section 50, because income tax statutes do not tax Indian tribes to begin with.
- IRC section 50(b)(4) provides, in part, that no investment credit shall be determined under Subpart E with respect to property used by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing. IRC section 7871 does not list IRC section 50 as a code section for which an Indian tribal government is considered a State or political subdivision. An Indian tribal government is, therefore, not a governmental unit described in IRC section 50(b)(4).

Energy projects on government sites

Energy projects on government sites

- DOE request for comments on tax treatment of Energy Savings Performance Contract Energy Sales Agreement (ESPC ESA)
- The 2012 OMB Memo
 - For an ESPC or UESC (Utility Energy Service Contract) to be scored on an annual basis..., the Federal government must retain title to the installed capital goods at conclusion of the Contract
 - Problematic for the ITC because of tax-exempt use rules
 - Service contract vs. lease
 - The long-term nature of these contract (25 year term) calls into question tax ownership especially when title automatically transfers at the conclusion of the contract
- IRC section 7701(e)(3) provides that an arrangement will be treated as a service contract provided none of the following four elements in present:
 - The service recipient (or a related entity) operates the facility;
 - The service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement, other than for reasons beyond the control of the service provider;
 - The service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement;
 - The service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or part of such facility at a fixed and determinable price, other than for fair market value.

Energy projects on government sites

- DOE proposed the following statement in forthcoming IRS or Treasury guidance
 - The mandatory title transfer required by the 2012 OMB Memo, will not disqualify an ESPC ESA project from being a service contract, so long as the transfer takes place at fair market value pursuant to 26 U.S.C. § 7701(e)(4)(A)(iv).
- SEIA requested additional clarifications
 - Transfer may take place at FMV or at a price equal to the higher of FMV and a fixed purchase price
 - Title transfer will not adversely affect eligibility of service provider to claim federal income tax benefits associated with tax ownership (i.e., ITC)
 - Contract term of 25 years will not adversely affect eligibility of service provider to claim federal income tax benefits associated with tax ownership

Placed-in-service rules for solar energy property

Placed-in-service rules for solar energy property

PLR 201611011

- Issued December 10, 2015 (released to public March 11, 2016)
- Taxpayer requested the following rulings:
 - Project B will not be precluded from being in placed service in Year for federal income tax purposes of sections 38, 46, 48, 167, and 168, even if the permanent Project B Interconnection Facilities are not completed in Year, as long as Project Company B rotates Project B Circuit usage across the T-Line so that each Project B Circuit, and thus Project B is operating on a regular basis during Year.
 - Project A will not be precluded from being considered placed in service in Year for federal income tax purposes of sections 38, 46, 48, 167, and 168, even as a result of the T-Line arrangement, as long as Project A will operate at h% capacity (on both Project A Circuits) for at least one week prior to initiating the T-Line arrangement, and as long as Project Company A rotates Project A Circuit usage across the T-Line so that each Project A Circuit, and thus Project A is operating on a regular basis.
- Similar to prior wind PLRs on placed in service
- Helpful for future PIS determinations (especially in 2020–2024)

Repowering wind projects

Repowering wind projects

- Some wind manufacturers approaching wind clients about “repowering” wind farms that are past the 10-year PTC period
- Opportunity to replace components of wind turbines (e.g., nacelle, blades, hubs) with new technology
- If the cost of the new property is 80% or more of the total cost of the new property plus fair market value of the used facility, then the facility is considered placed in service anew restarting the 10-year PTC period
- Potential issues:
 - How to value the new and used property (e.g., cost, income approach)
 - Include shared components (e.g., transformer, SCADA)?
 - Include value of PTCs?
 - Tax equity comfort?
- Government unlikely to issue PLRs or further guidance

Final REIT regulations

Final REIT regulations

- Final regulations (released August 30, 2016) clarify proposed regulations (released May 14, 2014) on section 1.856-10, definition of real property for REIT purposes
- Proposed regulations:
 - Examples 8 and 9 discussed solar energy sites
 - Foundations, racks and exiting wires are real property for REIT purposes
 - PV panels are not real property for REIT purposes
 - Did not provide the boost for new REITs that the solar industry hoped
 - Provided a benefit for existing REITs that will own solar property on their buildings
 - Built on PLR 201323016 and solar REITs
 - Solar property must be both inherently permanent and integrated structurally and functionally with the building allowing self-consumed generation to benefit the building owner or tenant
 - NOT the same as treating a solar farm as real estate when the property generates electricity for sale to a third party (net metering or PPA)

Final REIT regulations

In the preamble, Treasury and IRS describe suggestions considered but not adopted including:

- Treating solar energy assets as real property even if they are not serving as structural components; and clarifying what “indefinitely” means in the context of determining whether an asset is permanently affixed.

Treasury and IRS did adopt several changes:

- A temporary safe harbor for owners of solar energy assets that supply electricity to a building and its tenants but also provide some electricity to the grid (i.e., transfers of excess electricity to a utility company). Specifically, until additional guidance is issued, in any taxable year in which (1) the excess electricity transferred to the utility company does not exceed (2) the electricity purchased from the utility, the IRS will not treat the transfer of such excess electricity as affecting the qualification of the distinct assets that produce the electricity as structural components of the IPS for REIT purposes, will disregard any income resulting from the transfer of such excess electricity for purposes of the 75% and 95% REIT gross income tests, and will not treat any net income resulting from the transfer of such excess electricity as subject to the 100% prohibited transaction tax.
- Note, however, that the preamble does not address whether, if the ultimate guidance is less favorable, the IRS will grandfather transactions entered into prior to the issuance of the ultimate guidance.
- The final regulations revise Example 9 to state that "the size and other specifications of the solar energy system were established to serve the needs of the office building and that no facts indicate that the solar energy system will not remain in place indefinitely." Example 9 describes a particular REIT structure as one in which, "although the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company, the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building."

Treasury and IRS will consider whether additional guidance is necessary to potentially clarify "occasionally" in the example.

Contact

Gary Hecimovich
Deloitte Tax LLP
ghecimovich@deloitte.com

Joel Meister
Deloitte Tax LLP
jmeister@deloitte.com



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