Investment Tax Credits and Grants – Eligible Costs and Basis

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September 28, 2015

Agenda

- Overview
- Eligible Energy Property
- Eligible Basis – Overview
- Determining Eligible Basis – Purchased Projects
- Determining Eligible Basis – Developed Projects

Overview

Federal Incentives for Investment in Alternative Energy Projects

- Multiple options available
  - Production tax credits (PTC)
  - Investment tax credit (ITC)
  - ITC in lieu of PTC
  - Section 1603 Treasury grants
- Key project factors to determine the most advantageous option
  - Capacity factor of project
  - Total cost of project
  - Size of project
  - Need for and cost of monetization of credits
  - Tax position
  - Ratemaking

Investment Tax Credit

- Investment Tax Credit provided for under Section 48, with certain requirements and restrictions included in Section 50:
  - One-time federal income tax credit (30% or 10% of eligible basis in qualifying assets)
  - Placed-in-service requirements, but no beginning-of-construction requirements
  - 50% basis reduction of property
  - Recapture applies to most dispositions
  - Normalization required for rate-regulated utilities

Qualifying Resources and Facilities

Energy property	ITC rate *	Placed-in-service date	Notes
Solar	30%	Before 1/1/2017	
	10%		
Fuel cell	30%	Before 1/1/2017	
Stationary microturbine	10%	Before 1/1/2017	
Geothermal heat pump	10%	Before 1/1/2017	
Small wind	30%	Before 1/1/2017	
Combined heat/power	10%	Before 1/1/2017	
Geothermal	10%		Alternatively, PTC is available.

* Available for public utility property in tax years ending after 2/13/2008.

Qualifying Resources and Facilities *(cont.)*

Qualified resources/facilities	PTC amount for 2015 *	Termination date **	30% ITC election
Wind	2.3 cents/kwh	Before 1/1/2015	Placed in service after 2008 and construction beginning before 2015
Geothermal	2.3 cents/kwh	Before 1/1/2015	
Closed-loop biomass	2.3 cents/kwh	Before 1/1/2015	
Open-loop biomass	1.2 cents/kwh	Before 1/1/2015	
Landfill gas	1.2 cents/kwh	Before 1/1/2015	
Trash	1.2 cents/kwh	Before 1/1/2015	
Hydropower	1.2 cents/kwh	Before 1/1/2015	
Marine and hydrokinetic renewables (including small irrigation power)	1.2 cents/kwh	Before 1/1/2015	

* Adjusts for inflation. Available for a 10-year period.
** Date by which construction must begin.

Eligible Energy Property

ITC-eligible Energy Property

- In the case of energy property originally described under Section 48, each type of eligible property is delineated under Section 48(c)
- With respect to energy property which is part of a Section 45 qualified facility, Section 48(a)(5) provides the property must be:
  - Tangible personal property or other tangible property used as an integral part of the qualified facility (not including buildings or its structural components)
  - Depreciable or amortizable (in lieu of depreciable)
  - Used in the generation of electricity
  - Non-inclusive of any transmission equipment

ITC – Energy Property Examples

- Geothermal property*
  - Screening or slotting liners
  - Tubing
  - Downhole pumps
  - Pipes and ductwork
- Solar property*
  - Collectors
  - Hot liquid storage tanks
  - Thermostats
  - PV panels
  - Panel racking
- Wind property*
  - Turbine
  - Pad
  - Storage devices
  - Power conditioning equipment
- Biomass property
  - Boilers
  - Burners

* Reg. Sec. 1.48-9

ITC – Energy Property Examples *(cont.)*

- Microturbine property*
  - Gas turbine engine
  - Combustor
  - Recuperator / regenerator
  - Generator/ alternator
- Fuel cell property*
  - Fuel cell stack assembly
  - Fuel conversion plant components

* Section 48(c)

Property That is Not Eligible for ITC

- Section 50(b) provides the following property is not eligible for ITC:
  - Property used predominately outside of the United States
  - Property used by certain tax-exempt organizations, including:
    - Property owned by the tax-exempt entity
    - Property leased to the tax-exempt entity
  - Property used by governmental units or foreign persons or entities

Roadways

- Roadways that are integral to the functioning of the facility are ITC-eligible
  - Section 1603 Grant guidance provides that roadways located at the eligible facility used in maintaining and operating the facility, integral to the activity performed there, are grant eligible property
  - ITC guidance provided in Revenue Ruling 71-555 provides that roadways essential to the completeness of the taxpayer's qualifying activity are eligible for ITC

Roadways *(cont.)*

- Beginning-of-construction FAQ #6 indicates that roads on the site that are integral to the qualified facility are specified energy property, including onsite roads that are used for moving materials to be processed (e.g., biomass) and roads for equipment to operate and maintain the qualified facility
- FAQ #6 also indicates that roads for access to the site, or roads used solely for employee or visitor vehicles are not specified energy property

Transfer Equipment – Grant Guidance

- For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines
- Consistent with ITC definitions in Reg. Sec. 1.48-9

Substation High-side Equipment

- A typical substation contains multiple pieces of equipment after the voltage is stepped up by the main transformer to the transmission voltage. Each piece of equipment has a different function within the substation. This equipment includes:

  - Power circuit breakers
  - High voltage bus-bars
  - High voltage bus-bar supports
  - Potential transformers
  - Lighting and surge arrestors
  - Station surge arrestors
  - Post insulators
  - Suspension insulators
  - Air break switches
  - Grounding switch
  - Takeoff structures

Substation Property – CCA 201122018

- The issue whether a particular item of property is qualified property for purposes of Section 1603 Treasury grants turns on the following two questions:
  – Is the equipment used an integral part of the activity of generating electricity from wind?
  – Does the equipment constitute power conditioning equipment, transfer equipment, or parts relating to the functioning of those items?
- Relevant authority
  – Treasury grant guidance, Reg. Secs. 1.48-1 and -9

Substation Property – CCA 201122018

1. Dead end structure — clearly qualified equipment
2. Grounding XFMR — clearly qualified equipment
3. Switch gear building — clearly qualified equipment
4. Switch 34.5 KV — clearly qualified equipment
5. Transformer 34.5 KV to 345 KV — clearly qualified equipment
6. (Lightning or surge) arrester — clearly relates to the functioning of the transformer
7. 345 KV switch — directly relates to the functioning of the transformer
8. Metering CT — necessary part of the transfer equipment
9. 345 KV circuit breaker — necessary part of the power conditioning and transfer circuit
10. 345 KV switch — qualified even if item #11 is not
11. Dead-end surge arrester — subject to further investigation, could be part of the transmission activity

Storage Device – PLRs 201142005, 201208035 and 201308005

- Section 48 energy property includes storage devices associated with wind farms or solar generation systems
  - Main function — manage deliveries of wind electricity to the grid to an appropriate time
  - Does not constitute transmission equipment
- Storage devices are tested for ITC recapture separately from the rest of the generation facility under the “75% cliff”

Issues to Consider

- The eligibility of property for ITC is not necessarily determinative for purposes of MACRS tax depreciation classification
  - Certain roadways
  - Other land-improvements directly related to generation
  - PPAs acquired with power plants
- Similarly, the eligibility of property for credit purposes is not determinative for purposes of property tax assessments or sales and use tax assessments
  - Determinations will be made on a jurisdiction-by-jurisdiction basis as many have abatements for alternative energy property
  - Definition of “alternative energy property” varies

Eligible Basis – Overview

ITC-eligible Energy Property Basis

- Section 48(a) provides that the ITC amount is equal to the energy percentage of the basis of energy property placed in service during the taxable year
- Section 48(a)(3) provides that energy property must be:
  - Constructed, reconstructed or erected by the taxpayer or acquired by the taxpayer if original use commences with the taxpayer
  - Subject to depreciation or amortization (in lieu of amortization)
  - In accordance with required performance standards, if applicable

ITC-eligible Basis

- The eligible basis is the amount which is depreciable or amortizable
  - Includes direct and indirect costs using the capitalization rules of Sections 263(a) and 263A
- If other grants or incentives are received with respect to the property that are deemed non-taxable under Section 118(a), depreciable basis of the property is reduced under Section 362(c)
  - Credit amounts are reduced if depreciable basis is reduced
- After credit is computed, basis in the property for depreciation purposes is reduced by 50 percent of the credit

Determining Eligible Basis – Purchased Projects

Eligible Basis – Purchased Projects

- Many alternative energy projects purchased by the taxpayer are "turnkey," whereby the taxpayer is buying the entire project to be placed in service
- The taxpayer is acquiring a grouping of assets by purchasing the project:
  - Tangible personal property eligible for ITC
  - Tangible personal property not eligible for ITC
  - Real property (not eligible for ITC)
  - Intangible assets (not eligible for ITC)

Taxable Asset Acquisitions

- The buyer and seller must assess whether the transferred assets constitute a trade or business for federal income tax purposes
- Assets constituting a trade or business
  - Consistency requirement and tax return reporting
  - Residual method of Reg. Secs. 1.338-6 and -7
- Assets not constituting a trade or business

Purchased Project Examples – Facts

- Independent Power Producer, Inc. pays $100 million to Solar Development, Inc. for a turnkey 15 MW solar facility. The Company must allocate its $100 million purchase price to the assets acquired on the basis of the fair value of the assets and determine which assets are eligible property.
- The project includes the following assets:

  - Solar panels
  - Solar racks
  - Wiring
  - O&M building
  - Furniture and fixtures
  - Fencing
  - Access roadways
  - Substation / switchyard
  - Interconnection agreement
  - PPA with Public Utility, Inc.

Purchased Projects Example #1

Assume the sum of the asset fair values exceeds the total purchase price (e.g., project was a “bargain”) and the assets do not constitute a trade or business:

Asset	Fair Value	Allocated Purchase Price
Solar panels	$ 75.00	$ 65.22
Solar racks	9.00	7.38
Wiring	7.85	6.83
O&M building	0.25	0.22
Furniture and fixtures	0.25	0.22
Fencing	0.15	0.13
Access roadways	1.50	1.30
Substation / switchyard	5.00	4.35
Interconnection agreement	1.00	0.87
PPA with Public Utility, Inc.	15.00	13.04
Total Project	**$ 115.00**	**$ 100.00**

Purchased Projects Example #2

Assume the sum of the asset fair values exceeds the total purchase price (e.g., project was a "bargain") and the assets do constitute a trade or business:

Asset	Fair Value	Allocated Purchase Price	
Solar panels	$ 75.00	Class V	$ 75.00
Solar racks	9.00	Class V	9.00
Wiring	7.85	Class V	7.85
O&M building	0.25	Class V	0.25
Furniture and fixtures	0.25	Class V	0.25
Fencing	0.15	Class V	0.15
Access roadways	1.50	Class V	1.50
Substation / switchyard	5.00	Class V	5.00
Interconnection agreement	1.00	Class VI	0.06
PPA with Public Utility, Inc.	15.00	Class VI	0.94
Total Project	**$115.00**	**$ 100.00**	

Projects Purchased with PPAs

- PLR 201214007 held that that where Taxpayer acquired wind energy facilities subject to facility-specific PPAs, no portion of its purchase price shall be allocated to the PPAs and the purchase price of such wind energy facilities that is attributed to such PPAs shall be taken into account in determining the adjusted basis of the wind energy facilities

- PLR 201249013 revoked PLR 201214007, and stated that portion of purchase price allocable to PPA should be allocated to the PPA and not the facilities purchased

Taxpayer Bound by Original Price Allocation

- Issue – Whether the taxpayer can modify its original Section 1060 purchase price allocations for its acquired assets when determining the assets' useful lives
- Holding in *Peco Foods, Inc.*
  - Terms used in the original allocation schedule were not ambiguous, so ambiguity did not make the agreement unenforceable
  - Taxpayer is bound by the original purchase price allocations under IRC § 1060(a)
  - Original allocation schedule prevented any potential "whipsaw" to the IRS

Purchased Projects Summary

- The critical aspects of the exercise of determining eligible basis for credit for purchase property include:
  - Identifying all assets purchased
  - Quantifying the fair value of assets purchased
  - Allocating purchase price to the assets purchased
  - Computing the credit based on allocated purchase price of eligible units of property

Determining Eligible Basis – Developed Projects

Eligible Basis – Developed Projects

- For many renewable energy projects, the taxpayer placing the alternative energy project in service is responsible for contracting, supervising and paying for the development of the project
- The taxpayer is acquiring assets and paying for services throughout the development cycle of the project, incurring the following types of costs:
  - Direct costs
  - Indirect costs
  - Interest costs

Expensed Costs Overview

- Costs expensed for GAAP purposes may or may not be currently deductible for tax purposes:
  - Preliminary activities
    - Planning
    - Designing
    - Exploration
  - Marketing, selling and advertising costs
  - Research and experimental expenditures
  - G&A costs not related to construction
- Otherwise deductible costs incurred by start-up companies may be capitalized under Section 195 and are not project asset basis costs

Direct Costs Overview

- Eligible basis includes that basis which is depreciable, but generally does not include amortizable costs
- Reg. Sec. 1.263(a)-2 addresses amounts paid to acquire or produce tangible property
  - Generally effective for tax years beginning on or after January 1, 2014
  - Various elections

Indirect Costs Overview

- Section 263A requires the capitalization of all direct and certain indirect costs incurred by reason of the construction or production of real property and tangible personal property to the basis of such property
  – Taxpayers must allocate costs to various production activities and then allocate those production activity costs to the items or property produced
  – Amounts are capitalized for the items that remain on hand at the end of the taxable year
- Consider use of the direct reallocation method and elections under Section 266

Indirect Costs

Indirect costs incurred by reason of the construction or production of the property may include:

- Indirect labor
- Employee benefits
- Handling
- Depletion
- Insurance
- Engineering
- Quality control
- Non-income taxes
- Officers' compensation
- Indirect materials
- Storage
- Successful bidding
- Rent
- Utilities
- Spoilage
- Occupancy costs for "pick, pack, and ship" activities
- Pension, etc.
- Purchasing
- Cost recovery
- Interest
- Repairs and maintenance
- Tools and equipment
- Licensing fees
- Capitalizable service costs

Indirect Costs

- Indirect costs may be incurred with respect to:
  - The entire project
  - A portion of the project, comprising several categories of assets
  - One category of assets
- Indirect costs and interest capitalized must be allocated to the category to which the costs are applicable to determine total basis of each category of asset
- Eligibility of the property is determined after allocation of indirect costs (including capitalized interest) is completed

Indirect Costs – Development Fees

- Development fees are typically amounts paid to the developer by the purchaser of the alternative energy project
  - The payment may represent the “profit” earned by the developer
  - The payment may represent a payment for services of the developer
- Development fees may be between unrelated parties or related parties

Indirect Costs – Development Fees *(cont.)*

- There has been particular scrutiny on the acceptability of development fees for grant-eligibility purposes, particularly between related parties
- Corporate affiliates – Reg Sec. 1.1502-3(a)
  - ITC basis may not include any gain or loss by another member
  - Also applies to capitalizable services provided by an affiliate under Reg. Sec. 1.1502-13
- Other related parties (Section 482 transfer pricing rules)
  - Applies to gross income, deductions and credits
  - IRS has ability to re-allocate
  - Arms' length prices

Evaluating Cost Basis for Solar Photovoltaic Properties

- Treasury review procedures
  - Compare the claimed basis to certain benchmarks
    - If claimed basis is deemed consistent with benchmark prices, the review team typically focuses the remainder of its cost review on examining line items provided in the detailed cost breakdown to ensure that only eligible items have been included and that no costs have been inappropriately attributed to the property
  - The Section 1603 review team will accept a cost approach that includes only eligible property and a markup that is consistent with industry standards and with the scope of work for which the markup is received. While appropriate markups are case-specific and can depend on the ultimate transaction price, the 1603 review team has found that appropriate markups typically fall in the range of 10 to 20 percent. A cost approach that includes a markup should explicitly address the appropriateness of the selected markup in light of the activity, capital investment, and risk for which that markup is compensating.

Evaluating Cost Basis for Solar Photovoltaic Properties *(cont.)*

- Applications with a claimed basis that is materially higher than benchmarks will receive closer scrutiny
  - Related party considerations or unusual circumstances
    - Owner/applicant is related to the developer, installer, or supplier
      - Separate, legally-organized business, but there is common ownership/control
    - Owner/applicant is a party to one or more related transactions with the developer such that economic interests in the specific transaction determining basis may not be adverse
  - In this context, the owner/applicant may be asked to submit a more detailed cost breakdown. Specifically, original manufacturer's invoices/costs to the developer should be provided for major equipment, subsequent markups by the developer should be enumerated, and any markups by the owner identified. The owner may also submit a detailed and credible third-party appraisal demonstrating that the claimed basis is consistent with a market transaction between unrelated parties with adverse economic interests.

Capitalized Interest

- Self-constructed assets are subject to the interest capitalization rules of Section 263A(f) during the production period of property that has:
  - A long useful life, OR
  - An estimated production period exceeding two years, OR
  - An estimated production period exceeding one year and a cost exceeding $1 million
- Property has a long useful life if it is:
  - Real property, OR
  - Property with a class life of 20 years or more

Capitalized Interest

- Is the alternative energy plant real property or personal property for interest cap purposes?
  - Real property includes inherently permanent structures
  - Machinery or equipment is not an inherently permanent structure or real property
- If the plant is real property:
  - Interest capitalization applies to projects with less than a one-year construction period
  - The production period begins when physical activity is first performed either by taxpayer or contractor

Cost Segregation Analyses – Depreciation and ITC

Prior to Construction

- Key project participants are informed of their project cost reporting responsibilities
- May have initial or preliminary analysis based upon project budget estimate for lenders/financial institutions verification of MACRS / ITC

During Construction

- Technical documentation and review of project cost reports and general ledger amounts for purposes of MACRS classification and ITC eligibility

After Construction

- Basis reduction to applicable property

Analysis Process Steps

Questions?

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