

CLIENT ALERT

IRS Requests Comments on Potential Investment Tax Credit Regulations

November 13, 2015

The investment tax credit (ITC) provides a credit of up to 30 percent for investments in qualifying "energy property." In October 2015, the IRS released Notice 2015-70, stating that it anticipates issuing new regulations with respect to the ITC. The Notice requests comments on the types of property that should be eligible for the credit as well as the definition of different types of energy property. Any new regulations are likely to have a large impact on ITC availability for renewable energy projects, new technologies, and companies in the storage space. Comments are due February 16, 2016.

Background

Section 48 of the Internal Revenue Code provides an energy credit equal to a certain percent of the cost of each "energy property" placed in service during the taxable year. The applicable percentage is 30 percent or 10 percent depending on the type of "energy property." For example, the credit is 30 percent of the cost of certain solar property placed in service before January 1, 2017.

Energy Property

The ITC is generally available for the following types of energy property:

- Equipment that uses solar energy to generate electricity to heat or cool (or provide hot water for use in) a structure, to provide solar process heat, or to illuminate the inside of a structure
- Equipment used to produce, distribute, or use energy derived from a geothermal deposit but only, in the case of generated electricity, up to (but not including) the electrical transmission stage
- Qualified fuel cell property
- Qualified microturbine property
- Combined heat and power system property
- Qualified small wind energy property
- Equipment that uses the ground or groundwater as a thermal energy source or sink to heat or cool a structure.

The statute defines some of these terms, and Treasury Regulations from 1987 (predating the modern ITC) provide additional guidance. In many cases, however, it is unclear which components of a facility will qualify for the ITC.

Request for Comments

The Treasury Department and IRS have requested comments in five specific areas:

1. Whether only property that actually produces electricity may be considered energy property or whether property such as storage devices and power conditioning equipment may also be considered energy property.
2. Whether dual-use property should qualify for the credit and, if so, under what circumstances. If it should qualify, what portion of the basis of dual-use property should be taken into account in computing the credit.
3. Comprehensive definitions of energy property.
4. Definitions of terms such as storage devices, power conditioning equipment, transfer equipment, and other property commonly used in conjunction with energy property.
5. The need for other energy-related definitions.

Deadline

Comments must be received by February 16, 2016. Once the comment period is over, the Treasury Department and IRS will review the comments to determine what (if any) guidance to provide. If the IRS then issues proposed regulations, a process that might take a year or more, taxpayers will have additional time in which to comment before final regulations are published.

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Storage

There is currently no separate federal tax incentive for energy storage. Under current regulations, however, wind and solar energy property includes storage devices integral to the generation of wind or solar electricity. In two private letter rulings, summarized below, the IRS has held that storage devices incorporated into wind farms were qualifying property for purposes of the ITC.

PLR 201142005 addressed whether a storage device with a number of lithium-ion batteries was qualifying property. The storage device was situated on the generating, low-voltage side of the project substation, like the wind turbines. The storage device enabled the wind farm to manage deliveries of wind electricity to the grid and also allowed the project to provide regulation services to the grid. The IRS held that the storing of electricity for use at a later time is a classic use of a battery, and thus the storage device, in its entirety, would constitute qualified property for purposes of the ITC.

PLR 201208035 involved a wind farm that employed a large storage device comprised of advanced lead batteries to store electricity to work around transmission constraints and shift deliveries from off-peak hours to peak hours to earn higher rates. Again, the storage device was installed on the low-voltage side of the substation, and the device could be used to provide regulation services to the grid. That is, the device could both release electricity into the grid as well as allow the grid to shed electricity to the device. Nevertheless, the IRS determined that the storage device would not be used by any property other than the wind farm and was qualified property in its entirety.

It is not clear whether the IRS's recent request for comments suggests that the government is now retreating from its position that storage devices can qualify as energy property. Such a position would be contrary to the current administration's policies of clarifying and expanding tax benefits for renewable energy technology. In addition, energy storage has emerged in recent years as an efficient, environmentally friendly resource that can both increase the capacity factor of intermittent resources like wind and solar power, and help to moderate peak load demands on the grid and thereby defer or obviate the need for significant new

infrastructure projects like transmission lines and utility-scale power plants. Taxpayers should encourage the government to use the regulations to provide specific guidelines and examples of storage devices that qualify for the credit.

Dual Use Property

Under the current regulations, in some cases, the ITC is available for property only to the extent it uses qualifying sources of energy. For example, solar energy property does not include equipment that uses a source of power other than solar energy to produce usable energy. This equipment is energy property only if its use of energy from solar sources is at least 75 percent of its total energy input in an annual measuring period, and then only on a proportionate basis. That is, auxiliary equipment that would otherwise qualify for the credit but has a solar energy input equal over the annual measuring period equal to 80 percent of its total energy input will only be eligible for 80 percent of the credit. If the total energy input were only 70 percent, the auxiliary equipment would not qualify for any credit.

The IRS applied the dual use rules to storage in PLR 201308005, which involved a battery installed along with a solar photovoltaic system. The battery's primary use was to allow the customer to store energy generated by the solar panels during the day for use at night. However, the battery also allowed the customer to save money by storing electricity from the grid during off-peak hours to be used by the customer during peak hours or supplied back to the grid during peak hours under a net metering arrangement. Because the battery would be used to store (non-solar generated) electricity from the grid for use by the customer, the IRS ruled that the battery was subject to the 75 percent floor and only a proportionate amount of the ITC would be allowed for the battery. This ruling should be compared to the wind battery rulings discussed above, in which the IRS allowed a credit for the entire cost of the wind farm battery notwithstanding that it could be used to provide grid regulation services (and thus to draw energy from the grid). The distinction in the IRS's mind may be the fact that the solar battery drew electricity from the grid to benefit the customer, rather than the grid.

Taxpayers should consider proposing alternative rules for dual use property for consideration by Treasury and the IRS in developing the new regulations. For example, should a similar cliff apply, and if so what is the right threshold? For this purpose, should all electricity on the grid be treated as "dirty" even if a grid in general has 20 percent solar energy? Should there be a distinction (as the IRS seems to have drawn in the rulings discussed above) between electricity drawn from the grid to provide regulation services, as opposed to electricity drawn to benefit the customer?

Definitions

While current regulations provide that wind and solar property include storage and power conditioning equipment, the regulations do not define these terms. In CCA 201122018, the IRS concluded for purposes of section 1603 that power conditioning equipment included the step-up transformer that increased the voltage of the electricity generated by a wind farm to the voltage of the transmission line.

A number of other uncertainties exist under current law with respect to the definition of energy property, including the extent to which structural and building components, as well as land improvements, can qualify for the credit.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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