

# ITC – PHASING DOWN WHILE RAMPING UP

THIS ARTICLE SURVEYS THE PHASING DOWN OF THE INVESTMENT TAX CREDIT AVAILABLE FOR RENEWABLE ENERGY FACILITIES, WITH A FOCUS ON QUALIFYING STORAGE FOR THE ITC. BY **SAM KAMYANS**, PARTNER, **AKIN GUMP STRAUSS HAUER & FELD**.

Related, this article summarises the revised carbon oxide sequestration credit (the COS Credit) enacted for taxable years beginning in 2018. The revised COS Credit is in the early stages of commercial viability and financial modelling, and this article considers some structuring issues with respect to the revised COS Credit as taxpayers await guidance from the Internal Revenue Service (IRS).

## ITC – Storage considerations

Recent legislation enacted a phasing down of the investment tax credit (ITC). Specifically, the ITC is 30% of the eligible basis of energy property the construction of which begins prior to January 1 2020, 26% if construction begins prior to January 1 2021, 22% if construction begins prior to January 1 2022, and 10% thereafter.

The IRS issued Notice 2018-59 (the Safe Harbor) to provide a method on which taxpayers could rely to establish they had started construction on a facility for the purposes of establishing the rate at which they could claim an ITC.

The guidance, while addressing all technologies under Section 48 of the Internal Revenue Code (Code) skews heavily towards photovoltaic (PV) facilities used to generate electricity.

Notably absent from the Safe Harbor is any mention of a storage facility. Two motivations for this omission may be in play. The first is that IRS Notice 2015-70 requested comments on issuing regulations that would, in part, provide guidance as to the eligibility of storage for the ITC and, as a result, the Safe Harbor's addressing of storage could preempt more robust guidance.

The second reason for this omission could be a signal that storage is, with respect to new facilities to which the Safe Harbor relates, adequately addressed in existing regulations. This latter reasoning is unlikely given the pronouncement in Notice 2015-70; however, an analysis of the existing regulations in light of the phase-down and recent technological innovations warrants further examination.

Treasury regulations promulgated under Section 48, and not updated since 1987, use broad strokes to define energy property in the ITC context, but are criticised for ostensibly failing to provide clarity to existing storage technologies. While more clarity from the IRS is always welcome, the existing regulations appear to provide a path to ITC qualification for at least certain storage devices.

At a high level, the regulations use the term “storage devices” in relation to “electric generation equipment”, which is a derivative of the broader “solar energy property” definition set forth in the regulations. Wind energy uses a similar construct, and discussions in this article with respect to solar apply equally to wind.

To ensure a storage device that can store electricity derived from solar and non-solar sources does not per se qualify for the ITC, the regulations limit the ITC eligibility of storage devices if those devices are “dual use equipment”.

Specifically, dual use equipment is ineligible if that device stores less than 75% solar-source electricity; moreover, if the storage device uses less than 75% solar-source electricity during the five-year recapture period, all of the ITC will be recaptured. Some recapture results if the storage is between 75% and less than 100%.

While a storage device's ITC eligibility is arguably supported by the regulations, application of the Safe Harbor for grandfathering a certain ITC percentage is less clear.

If a taxpayer accepts the premise that energy property for ITC purposes includes storage, and grandfathers a single facility that includes a PV plant and associated storage that is solely charged with electricity from the PV plant, then satisfying the Safe Harbor with respect to the

While more clarity from the IRS is always welcome, the existing regulations appear to provide a path to ITC qualification for at least certain devices

PV plant should qualify the storage component as well. Beyond this base case, the result is less clear.

Stand-alone storage, ie storage that is not clearly part of an existing PV plant, raises important questions. The first is practical in nature – verifying that a stand-alone facility is being charged solely with solar-derivative electricity.

Practical commercial solutions for this issue exist, though implementation does not guarantee ITC qualification. One example is to synchronise the battery operations with a PV plant so that the battery accepts electricity from a PV facility during periods of excess production.

Under this approach, excess electricity generated from a PV plant during certain periods – eg high noon during a mild, low-use period of the day – that the grid operator cannot accept are transmitted to the storage device.

Systems will have to be put in place, and an independent engineer should verify, that the inflows to the system will consist only of solar-source electricity. Because stand-alone storage can accept either solar or wind, the increased optionality expands the appeal of this approach. However, given the abundance of non-solar/wind electricity, verification is an important part of this equation.

Another way to solve for the tracing problem is to buy associated solar renewable energy certificates (SRECs). Producers of solar-derived electricity are given SRECs to verify that they have produced a certain quantum of electricity; typically, each SREC is issued in uniform blocks, eg a 5MWh or 1Kwh certificate.

An SREC is essentially a method on which a taxpayer can rely to verify that electricity it is using comes from a particular source, and SRECs are traded on a secondary market.

Utilising SRECs is a sensible method for a storage facility to verify that it only uses solar electricity for its storage device. The IRS has not publicly taken a position with respect to this approach, however, the IRS's arguments to the contrary would be troubling.

Specifically, each SREC is available only to the extent of the amount of solar electricity to which it relates. As a result, while all electrons are fungible, the universe of solar electricity is catalogued and tracked per the SREC system; while not all solar electricity is tracked in this fashion, the opposite, more important consequence is that all SRECs are associated with solar electricity.

Thus, a storage facility that charges and discharges electricity consistent with the amount of SRECs it buys and sells has a direct tracing mechanism with which to verify the requirements under the existing regulatory framework.

Any challenge of the SRECs as not substantiating the solar electricity requirement associated with storage leaves the IRS in a

position where it challenges the inherent validity of an SREC.

This position is premised on a lack of trust in the integrity of the SREC system, and would result in the IRS arguing before a court that a state programme is faulty or fraudulent.

While the IRS is free to take this stance, such a move is presumably prudent only in cases where it appears a state regulator has engaged in some fraudulent activity. Even then, it appears unnecessarily punitive to deny credits if the taxpayer had placed good faith reliance on the SREC system.

Given the choices, a taxpayer is well positioned to sustain an audit if it can keep substantiate stored electricity with SRECs. Accordingly, while there is a potential path for comfort in the absence of storage guidance, there are risks to be evaluated as part of taking the SREC approach to ITC qualification.

### Carbon sequestration – New rules

Perhaps the next phase of credits will come in the form of expanded opportunities from carbon sequestration technologies.

The enactment of the Bipartisan Budget Act of 2018 saw a shift in the existing carbon sequestration tax credit regime. Previously dedicated to carbon dioxide sequestration, the COS Credit has evolved to broaden its definition of carbon capture to include qualified carbon oxide.

With this broadened definition has come an expansion of projects eligible for the credit, as well as additional pricing provisions, categories for tax credits, and a provision regarding the implementation of additional carbon capture equipment on an existing qualified facility.

The COS Credit utilises a two-tier credit system presumably designed to reflect that the two sequestration activities set forth in the statute have different economics. Specifically, the regime provides a higher credit for carbon that is captured and stored, versus carbon that is captured and used in enhanced oil recovery (EOR) activities.

This appears to be a recognition that storing carbon in a geological location is a sunk cost whereas carbon used for EOR activities can be sold to an exploration and production company, thereby enabling a taxpayer to supplement the credit with a revenue stream.

For technologies that capture carbon and store the carbon in a geological location, the credit ranges from US\$22.66 to US\$50 per metric ton of captured carbon through to 2026, and beginning in 2027 the US\$50 is increased annually using an inflation escalator. For technologies that use captured carbon in EOR activities, the credit ranges from US\$12.83 to US\$35 per metric ton through to 2026, and beginning in 2027 the credit is increased by an inflation escalator.

The credit is available to the owner of the facility that directly, or indirectly through a

contractor, captures and stores, or captures and sells the captured carbon, provided the construction of the facility begins prior to January 1 2024. There is currently no guidance on how a taxpayer may start construction for this purpose.

The COS Credit functions similarly to the production tax credit for wind in that tax credits are earned as carbon is captured and runs for a period of 12 years. The COS Credit is subject to recapture, and the IRS has been delegated authority to issue recapture guidance.

Similar to wind and solar facilities, the COS Credit will rely on financial models to evaluate the credit and revenue streams in connection with sizing investments.

With respect to storage-only activities, the cost of the storage should be relatively predictable and the credit modelled in accordance with expected output.

However, storage-only activities are not going to give rise to a revenue stream, meaning an investor will see a return substantially, if not entirely, consisting of tax credits. A party that participates in the sale of carbon to EOR parties can tap into a revenue stream to supplement the lower credit.

In each instance, the tax and commercial structuring is critical. The immediate reaction for most taxpayers will be to use a flip structure for credit allocation. However, the dual tier construct of the credit invites new and innovative ways to court investments.

Specifically, if there are multiple ways to capture and resell or store carbon with respect to a single activity – eg an EOR party cannot

take all the carbon, resulting in some carbon requiring storage – one can conceivably have multiple facilities and credit streams related to a single facility.

Separate investors can enter into a partnership with a developer or a sponsor, which would require a series of special allocations and innovative credit sharing that is compliant with federal tax principles.

A serial limited liability company may be a useful tool for parsing out credit streams associated with one or more facilities as part of large project all within a single investment vehicle, but will require careful planning to satisfy the tax requirements for enabling and sharing the credit.

While the tax court has recently held in a refined coal credit case that relying solely on tax credits is permissible in a partnership context, it is not clear that the IRS will accept this reasoning in the COS Credit context. Moreover, if novel structures are developed, existing precedent may be insufficient.

Although one can reasonably see the IRS applying prior credit guidance in this space, at least for the start of construction and recapture, it is worth noting that a whole new body of law may be needed to reflect the economic posture of investors and the technology giving rise to the credit.

Accordingly, a successful investment will require careful planning along with a team of legal, financial and technology professionals that, if done correctly, can be a lucrative green investment. ■



Battery energy storage facility made of shipping containers | © Dreamstime.com