

Solar “Farms” and The Associated Tax Credit

Roger McEowen (roger.mceowen@washburn.edu)

Professor of Agricultural Law and Taxation, Washburn University School of Law

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Overview

The interest among some farmers and ranchers in converting some of their land into a “solar farm” is growing. The opportunity for additional cash in tough economic times is driving the interest. Is it a good investment? Of course, the boondoggles of Solyndra, LLC in California and Crescent Dunes in Nevada are a reminder that such ventures can turn up dry. In addition, the federal government encourages ventures into solar energy production with the use of taxpayer dollars.

Solar energy production and the tax credit for producing electricity from the sun – it’s the topic of today’s post.

Residential Energy Credit

Currently, a taxpayer may claim a residential energy efficient property credit of 26 percent credit for the costs of the solar panels and related equipment and material installed to generate electricity for use by a residential or commercial building. [I.R.C. §25D](#). A taxpayer is “allowed as a credit against the tax imposed...for the taxable year, an amount equal to the sum [of] the qualified solar electric property expenditures” – expenditures “for property which uses solar energy to generate electricity for use in a dwelling unit located in the United States and used as a residence by the taxpayer.” [I.R.C. §25D\(2\)](#). The credit is computed by taking into account the cost of solar panels as well as piping or wiring to connect the property to the dwelling unit plus labor costs. For a newly constructed home, the taxpayer may request that the homebuilder make a reasonable allocation, or the taxpayer may use any other reasonable method to determine the cost of the property that is eligible for the credit. *IRS Notice 2013-70, 2013-47 IRB 528, Q&A No. 21*.

A taxpayer that claims the credit for solar energy property installed in the taxpayer’s principal residence or vacation home must reduce the taxpayer’s income tax basis in the property by the amount of the credit. A “home” includes a house, houseboat, mobile home, cooperative apartment, condominium, and a manufactured home. *See Instructions to Form 5695, Residential Energy Credits*.

Commercial (Business) Energy Credit

[I.R.C. §48](#) provides a credit for “energy property placed in service during [the] taxable year.” [I.R.C. §48\(a\)\(1\)](#). The amount of the credit is a percentage of energy based on each energy property placed in service during the taxable year. The energy percentage is 26 percent for solar energy property that is under construction on or before December 31, 2020 and placed in service before January 1, 2024. The credit belongs to the owner of the solar energy property. The credit is claimed on Form 5695 with the amount of the credit carried to Form 1040.

IRS Notice 2013-70 provides taxpayers with two methods to establish the beginning of construction – either by starting physical work of a significant nature (the “Physical Work” test) or by satisfying a safe harbor (the “Five Percent Safe Harbor” test). Under the safe harbor, construction is deemed to begin when the taxpayer pays or incurs five percent or more of the total cost of the energy property



and thereafter makes *continuous efforts* to advance towards completion of the energy property. While either method may be used, construction is deemed to have begun on the date the taxpayer first satisfies one of the two methods.

Energy property is defined as any “equipment which uses solar energy to generate electricity to...a structure” and “equipment which uses solar energy to illuminate the inside of a structure.” [I.R.C. §48\(a\)\(3\)](#). The regulations provide additional guidance. Treas. Reg. §1.48-9(d)(1) provides that “solar energy property’ includes equipment and materials (and parts related to the functioning of such equipment) that use solar energy directly to (i) generate electricity (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure.” Treas. Reg. §1.48-9(d)(3) defines electric generation equipment as follows:

“Solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.”

In addition, Treas. Reg. §1.48-9(d)(4) specifies that “[p]ipes and ducts that are used exclusively to carry energy derived from solar energy are solar energy property.” Because the credit is part of the general business credit under [I.R.C. §38](#). Property that is eligible for the general business credit is tangible property for which depreciation is allowable.

The solar energy credit is part of the investment credit under [I.R.C. §46\(2\)](#) which means that it is subject to the rules that apply to unused general business credits under [I.R.C. §38\(a\)](#). Unused credit amounts are carried back one year and then to each of the 20 years following the unused credit year. The credit is nonrefundable and may only be used against the taxpayer’s actual tax liability. The entire amount of the unused credit must be carried back one year before it may be carried over to the next 20 years. [I.R.C. §39\(a\)\(2\)\(A\)](#).

The solar equipment can be owned by one party and used on another person’s property. In that situation, the owner/lessor may claim the energy credit provided that the solar property is placed in service and meets the other requirements of [I.R.C. §48](#). *Rev. Rul. 79-264, 1979-2 C.B. 92*.

As noted, the owner of the solar energy property is entitled to the energy credit. If IRS challenges the ownership issue in lessor/lessee situations, the most important factor in determining ownership is the source of capital for the solar energy property. The party that is exposed to the risk of loss from supplying the necessary capital for the asset and retaining an actual and legal proprietary interest in the asset is the owner of the property that is entitled to the credit.

A lessor of new solar energy property may elect to pass the credit to the lessee if the transaction involves a profit intent and the lease is a bona fide lease. The property is deemed to be placed in service when it is first held out for leasing to others in a profit-motivated leasing venture. *See, e.g., Cooper v. Commissioner, 88 T.C. 84 (1987)*. A sale/leaseback is also possible which allows the lessee to claim the credit or would permit the lessor to pass-through its credit to a lessee.

The solar energy credit can also be used to offset alternative minimum tax liability without limitation. [I.R.C. §38\(c\)\(4\)\(B\)\(ix\)](#). *See also I.R.C. §38(c)(4)(A)(i)*.

Recent Case

A recent U.S. Tax Court case, *Golan v. Comr.*, T.C. Memo. 2018-76, involved the solar energy credit as well as associated income tax basis, depreciation, at-risk and passive loss issues. The case is a good illustration of the issues that can arise when a farmer or rancher (or other taxpayer) gets involved with a “solar farm” project.

Fact of the case. In 2010, the petitioners (a married couple), sought an income-producing investment and thought they would do so by purchasing solar equipment from a seller of such equipment. The seller identifies property owners and offers them discounted electricity in exchange for permission to install solar panels and related equipment on their properties (known as “host properties”) The seller remains the owner of the solar equipment and temporarily retains the burdens and benefits of ownership (including all resulting tax credits and rebates). Then, the seller sells the solar equipment (and the associated rights and obligations) to a buyer such as the petitioners. An owner of a host property filed an application with the local utility company for an interconnection agreement (for net energy metering), and the seller entered into a power purchase agreement (PPA) with the owner of the host property. The seller, as noted, temporarily retained ownership of the solar equipment and was responsible for any servicing or repairs. The PPA barred the owner of the host property from assigning the PPA to another party without the seller’s consent, but the seller could assign it interest in the PPA to another party with 30 days’ notice to the host. Once the solar panels were installed, the utility company informed the host property owner of eligible rebates, which the host property owner assigned to the seller.

The sale of the solar equipment to the petitioners was accomplished in 2010 under a solar project purchase agreement coupled with a promissory note and guarantee that the petitioner’s signed. It was completed with a bill of sale and conveyance. The solar equipment was installed on the host properties in 2010, but under the purchase agreement, the “original use” of the solar equipment “shall commence on or after the Closing Date.” The purchase price was set at \$300,000, consisting of a \$90,000 down payment due on closing in early 2011; a \$57,750 credit for the rebates the seller received from the utility company before the sale; and the petitioners’ promissory note in the principal amount of \$152,250 with interest at 2 percent. The solar equipment secured the note and all monthly revenue generated from the solar equipment was to be applied to the note. If accrued interest exceeded monthly receipts for any particular month, the difference was to be carried forward and the petitioners would owe it in future months. If monthly receipts exceeded accrued interest and amortized principal, the excess would accelerate the loan’s repayment. Upon default, the seller would seek recourse against the solar equipment before exercising any remedies against the petitioners, and the petitioners were liable to pay any deficiencies owed to the seller if sale of the collateral upon foreclosure didn’t pay outstanding amounts owed to the seller. The petitioners also signed a guarantee for the note.

Ultimately, the petitioners failed to pay the down payment in 2011 but did make partial payment in 2012 and 2013. In addition, the petitioners directed the owners of the host properties to make direct payment of electricity bills to the seller who then credited the payments toward the note. The seller continued to honor the purchase agreement.

On their 2011 return, the petitioners Schedule C reported no income, but claimed various deductions including depreciation of \$255,000. The petitioners stated that the Schedule C business was as a “consultant” for the seller’s business. The petitioners were also on the cash method of accounting. The \$255,000 figure was arrived at as the difference between their claimed \$300,000 basis in the solar equipment and \$45,000. The \$45,000 was one-half of the \$90,000 energy credit claimed reduced by one-half in accordance with [IRC §§50\(c\)\(1\)](#) and (3)(A). On their associated

Form 4562, the petitioners stated that the \$255,000 deduction was a “[s]pecial depreciation allowance for qualified property.” Also attached to the 2011 return was Form 3468 on which they claimed a \$90,000 energy credit (30 percent of \$300,000).

The IRS disallowed the depreciation deduction on the basis that the solar equipment did not qualify for “bonus” depreciation because it was neither acquired after September 8, 2010 nor placed in service before January 1, 2012. The IRS also disallowed the energy credit claiming that the petitioners did not have a basis in the energy property because no funds changed hands. In addition, the IRS asserted that the petitioners were not at-risk with respect to the promissory note and, as a result, could not claim any basis in the note. The IRS based its position that the seller had a prohibited continuing interest in the solar equipment activity. See [I.R.C. 465\(b\)\(3\)](#). The IRS also took the position that the passive loss rules applied to the petitioners’ Schedule C loss and claimed solar energy credit. An accuracy-related penalty was also applied.

The Tax Court’s holdings:

- **Income tax basis.** Because the down payment of \$90,000 payment was not paid in 2011, that amount could not be applied to the petitioners’ basis in the solar property for 2011, citing Treas. Reg. §1.1012-1(a). As for the \$57,750 credit for the rebates assigned to the utility company by the owners of the host properties, the petitioners neither received them nor reported them as income. This amount could also not be applied to the petitioners’ basis in the solar equipment. It was not part of the petitioners’ cost of the solar equipment. The \$152,250 promissory note was a recourse obligation that was issued in exchange for the solar equipment. As such, the face amount of the note could be included in the petitioners’ basis in the solar equipment.

The result was that the petitioners’ income tax basis in the solar equipment was \$152,250.

- **Bonus depreciation.** The Tax Court determined that the solar equipment (which has a recovery period of 20 years) did qualify for bonus depreciation because the petitioners acquired it (as the original user) in January of 2011 and placed it in service that year. While the solar property was installed on the host properties in 2010, the IRS failed to prove that the property was connected to the grid in before 2011. As such, the solar property was not ready and available for its intended use until it was connected to the electric grid, and that was in 2011 rather than 2010.
- **At-risk rules.** The Tax Court disagreed with the IRS claim that the seller had a prohibited continuing interest in the solar equipment activity under [I.R.C. §465\(b\)\(3\)](#). The IRS failed to identify any provision of the purchase agreement entitling the seller to the solar equipment upon liquidation. Similarly, the seller was not shown to have an interest in the net profits of the petitioners’ solar energy venture. The right to have monthly revenue applied to the note was a permitted gross receipts interest. It was immaterial that the seller was also a promoter of the transaction.
- **Passive loss rules.** The petitioners claimed that the husband participated in the solar energy venture for at least 100 hours in 2011 and that his participation was not less than that of any other individual, thus satisfying the material participation test of Temp. Treas. Reg. §1.469-



5T(a)(3). The Tax Court viewed the husband's testimony as credible and that the IRS failed to establish otherwise.

- The Tax Court did not uphold the accuracy-related penalty, finding that the petitioners made a good faith effort to determine their tax liability and reasonably relied on the advice of their tax preparer.

Conclusion

The tax credit for solar energy electricity production is designed to incentivize solar energy production. But, there are other considerations besides tax in determining whether a "solar farm" investment is a good one for any particular farmer or rancher. Each situation is dependent on the facts. For those interested in a "solar farm" investment, seek good legal and tax counsel.

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K-State Agricultural Economics | 342 Waters Hall, Manhattan, KS 66506-4011 | 785.532.1504
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