LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

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STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

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RE: Relating to the Renewable Energy Technologies Income Tax Credit

This tax information release will clarify some of the issues surrounding the renewable energy technologies income tax credits provided by § 235-12.5, Hawaii Revised Statutes (HRS).

A. WHO MAY CLAIM THE CREDIT

Only the economic owner of the renewable energy technology system may claim the credit. The economic owner of the system need not be the owner of the property being served by the system.

The determination of who is the economic owner of a system is made at the time the system is installed and placed in service. The economic owner of a system is determined with reference to the facts and circumstances of the particular transaction. Although no single test will resolve the question of who the economic owner of the system is in every situation, the following general rules will be applied by the department when analyzing a transaction:

- In the situation of leasing the system or a sale-leaseback of the system, the determination of the taxpayer who is entitled to the credit requires an analysis of whether the transaction is, in fact, a lease or sale-leaseback for federal income tax purposes. The characterization of a transaction involving a system as a sale, lease, or sale-leaseback for federal income tax purposes determines who is the economic owner of the property and thereby entitled to the tax benefits associated with the system.
- If a transaction is a lease for federal income tax purposes, the lessor is the economic owner of the system. On the other hand, if the parties characterize a transaction as a lease, but it is in reality a sale for federal income tax purposes, the lessee is the economic owner of the system.
- If a transaction is a sale-leaseback for federal income tax purposes, the buyer/lessor entering into a sale-leaseback arrangement with respect to the system is the economic owner of the system.
- If a transaction is a sale for federal income tax purposes, the buyer is the economic owner of the system, even if title to the system passes to the buyer after the system is technically installed and placed in service by the seller, but only if the system is installed and placed in service at the direction of the buyer.

Example 1:

A developer on a speculative basis (meaning that the developer is not contracted to build the home for any specific person) plans to build and sell 50 homes, which are intended to be used as single-family residences. The developer plans to install and place in service a photovoltaic system on each of the residences during the construction of the homes. The developer is eligible to claim the credit, all other requirements for the credit being satisfied, if the developer purchases the system and installs and places it in service. The initial homeowner who then buys one of the residences from the developer will not be eligible to claim the credit, as that homeowner was not the economic owner of the system at the time the system was installed and placed in service.

Example 2:

A homeowner contracts for the purchase and installation of a photovoltaic system on her single-family residence. Because the installation and placing in service is contemporaneous with the purchase of the system being installed, the contractor would not be eligible to claim the credit even if the contractor originally purchased the system and then installed it and placed it in service prior to the passing of the title to the system from the contractor to the homeowner. The homeowner, being the economic owner of the system, would be the proper taxpayer to claim the credit. (For discussion regarding application of the appropriate credit cap, see sections D. and E., below.)

Example 3:

The owner of a hotel purchases a photovoltaic energy system for installation and use in the hotel. Immediately upon installation of the system in the hotel, taxpayer acquires the system pursuant to a sale-leaseback agreement with the hotel owner. Then the taxpayer leases the system back to the hotel as required for recognition of the transaction as a valid sale-leaseback transaction for federal income tax purpose. The taxpayer, not the hotel owner, will be considered the economic owner of the system when the system was installed and placed in service; and therefore is eligible to claim the credit.

B. WHEN THE CREDIT MAY BE CLAIMED

The owner of the system may only take this tax credit for a system that has been installed and placed in service during a taxable year. A renewable energy technology system is placed in service in the taxable year in which the system is placed in a condition or state of readiness and available for a specifically assigned function by the taxpayer. Both the installation and placement in service requirements must be satisfied during a particular tax year in order to claim the credit for that taxable year. However, not all installation activities must occur within the same taxable year that the system is ultimately placed in service. As long as any portion of the installation occurs in the same year that the system is placed in service, all installation costs incurred by the owner of the system in previous tax years that are related to the system in

question but not yet used in a claim of this credit due to the "placed in service" requirement, may be included in the actual cost during the taxable year that both requirements are finally met.

C. WHAT IS A SYSTEM?

The question of what constitutes a system for purposes of this credit continues to cause uncertainty among taxpayers desiring to take advantage of the tax credit provided at § 235-12.5, HRS. This question is important because a credit may be claimed for every eligible renewable energy technology system that is installed and placed in service by a taxpayer during the taxable year. The credit allowable for each system, however, is subject to a cap; and, therefore, the question of whether the installation of renewable energy technology constitutes the installation of one or more systems will directly affect the amount of credit available to a taxpayer.

"Renewable energy technology system" is defined by the statute as "a system that captures and converts a renewable source of energy, such as wind, heat (solar thermal), or light (photovoltaic) from the sun into:

(1) A usable source of thermal or mechanical energy;
(2) Electricity; or
(3) Fuel."

§ 235-12.5(b), HRS.

The statute also defines "Solar or wind energy system" as "an identifiable facility, equipment, apparatus, or the like that converts insolation or wind energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation." § 235-12.5(b), HRS. The undefined terms used in § 235-12.5(a)(1), (2), and (3) (respectively "solar thermal energy systems", "wind-powered energy systems", and "photovoltaic energy systems") will be defined with reference to the definition given for "solar or wind energy system." For purposes of this credit, the department will interpret the terms "solar thermal energy systems", "wind-powered energy systems", and "photovoltaic energy systems" as follows:

> "Solar thermal energy system" means an identifiable facility, equipment, apparatus, or the like that converts heat (solar thermal) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation.
>
> "Wind-powered energy system" means an identifiable facility, equipment, apparatus, or the like that converts wind energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation.
>
> "Photovoltaic energy system" means an identifiable facility, equipment, apparatus, or the like that converts light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation.

Therefore, as defined above, "solar thermal energy systems", "wind-powered energy systems", and "photovoltaic energy systems" are all "renewable energy technology systems" as that term is defined in § 235-12.5, HRS, because each captures and converts a renewable source of energy, such as wind, heat (solar thermal), or light (photovoltaic) from the sun into a usable source of thermal or mechanical energy, electricity, or fuel. As renewable energy technology systems, a taxpayer who installs and places in service a "solar thermal energy system", a "wind-powered energy system", or a "photovoltaic energy system" may claim the tax credit.

The key to answering the question of whether any installation of renewable energy technology constitutes the installation of one or more systems, therefore, depends upon identifying the facility, equipment, apparatus or the like that is converting insolation or wind energy into useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation. A system will only exist when all the components necessary for the conversion of insolation or wind energy into useful thermal or electrical energy are present.

Example 4:

Taxpayer installs and places into service three photovoltaic panels/arrays, one inverter, and associated attachment and connection equipment sufficient to make one connection to the project site's electrical system. The taxpayer has installed one system, not three.

Example 5:

Taxpayer installs and places into service three photovoltaic panels/arrays, three inverters, and associated attachment and connection equipment sufficient to make three separate, independent connections to the project site's electrical system. If the taxpayer installs each array to a separate inverter, which is connected to the project site's electrical system separately and independently of the other inverter-array combinations, the taxpayer has installed three systems.

The department interprets the statute's allowance of a credit for a system that is installed and placed in service by a taxpayer during the taxable year as allowing additions to existing systems to qualify for the credit in tax years following the year a system is initially placed in service. However, to be considered an addition, the installation and placing in service of equipment must be substantial and not constitute mere maintenance or repair of the existing system. All additions made to one existing system during a single taxable year will be treated as one installation with the aggregate cost subject to the cap as if a single system were installed and placed in service during that taxable year. While any number of additions may be made during a single taxable year, at least one of the additions made during the tax year in question must constitute or include an identifiable facility, equipment, apparatus, or the like that converts heat (solar thermal) energy, wind energy, or light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossils fuel for their generation; otherwise none of the additions will generate a credit because the definition of system will not have been met.

Example 6:

Taxpayer has an existing photovoltaic system and decides to add an additional solar panel array in January and then again in November. Since each solar panel constitutes an identifiable facility, equipment, apparatus, or the like that converts light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation, each installation will be considered an addition. The two additions will be treated as a single project and subject to a single cap.

Example 7:

Taxpayer has an existing photovoltaic system and needs to replace one of the solar panel arrays. In January, taxpayer replaces one array and adds an additional array. Since the replacement array constitutes maintenance or repair of the existing system, it does not qualify. However, the cost reasonably allocated to the installation of the additional array would qualify for the credit.

Example 8:

Taxpayer has an existing photovoltaic system and needs to replace the inverter. Since replacing the inverter constitutes maintenance or repair of the existing system, it does not qualify. Even if the replacement did not constitute maintenance or repair, it would still not qualify because it is not an identifiable facility, equipment, apparatus, or the like that converts heat (solar thermal) energy, wind energy, or light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossils fuel for their generation. The inverter does not convert light, heat, or wind into useful thermal or electrical energy, the solar panels do.

Example 9:

Taxpayer has an existing photovoltaic system and decides to add more solar panel arrays. As a result of adding the solar panel arrays, he needs to upgrade the inverter and the associated attachment and connection equipment for a reason other than maintenance or repair. Since the installation includes solar panels which constitute an identifiable facility, equipment, apparatus, or the like that converts light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuels for their generation, the entire cost of installation qualifies.

Example 10:

Taxpayer has an existing photovoltaic system and decides to add more solar panel arrays in January and December. In September, taxpayer decides to upgrade the inverter and/or associated attachment and connection equipment for a reason other than maintenance or repair (for

example, upgrading to more efficient equipment). The installations made in January, September, and December will be treated as a single installation subject to a single cap. Even though the installation in September does not include an identifiable facility, equipment, apparatus, or the like that converts heat (solar thermal) energy, wind energy, or light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuels for their generation, the September installation may be included in the aggregate actual cost because the January and/or December additions made during the same tax year do include the installation of an identifiable facility, equipment, apparatus, or the like that converts light (photovoltaic) energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuels for their generation.

If the taxpayer in this example did not make either the January or December addition, then the September addition, by itself, would not qualify for the credit. To include the cost of installing associated equipment that does not itself convert heat, wind or light, one of the additions made during a taxable year must include the installation and placing in service of an identifiable facility, equipment, apparatus, or the like that does convert heat (solar thermal) energy, wind energy, or light (photovoltaic) energy, such as a solar panel.

Example 11:

Calendar year taxpayer has an existing photovoltaic system. In September, taxpayer decides to upgrade the inverter and/or associated attachment and connection equipment for a reason other than maintenance or repair (for example, upgrading to more efficient equipment). As explained in example 10, taxpayer cannot claim this tax credit for the installation and placement in service of any equipment that does not convert heat, wind or light. Taxpayer decides to install an additional solar panel array in December. As explained in example 10, if taxpayer installs and places in service equipment that does convert heat, wind or light, then all additions to the system during the same taxable year will be treated as one addition, subject to one cap. In this case, the actual cost of the inverter in the September addition and the solar panel array in the December addition would be added together and treated as one qualifying addition during the taxable year, subject to the appropriate cap.

However, if, for purposes of this example 11, the solar panel array installation begins on December 30 and ends on January 2 of the next year, then the new solar array panel would be placed in service in the following tax year. Because the solar panel array was not placed in service until the next year, it cannot be included as an addition in the same year as the September inverter addition. Since no equipment that converts

heat, wind or light was added in the year the inverter was added, the September inverter addition does not qualify for the credit.

D. Types of Property Served by the System

The question of what constitutes a single-family residential property, multi-family residential property, and commercial property for purposes of this credit is also causing uncertainty among taxpayers desiring to take advantage of this tax credit. The maximum credit allowed for the installation of a renewable energy technology system depends not only upon the type of system being installed, but also upon the type of property being served by the system. The statute identifies, but does not define, three categories of property: single-family residential property, multi-family residential property, and commercial property.

The department begins its interpretation with the term property; the department interprets property to mean a single, definable portion of the real property located in this State as described in a title recorded with the Bureau of Conveyances and/or Land Court of the State of Hawaii and that the applicable law allows to be sold in fee simple separately from any other real property located in this State.

Once the physical boundaries of the property are determined, a characterization must be assigned. The department interprets this statute to mean that, for purposes of this tax credit, all such titled property in the State is to be characterized as commercial or residential, or a mix of the two. The department further interprets the statute to mean that any property being served by the renewable energy technology system that cannot be properly characterized as residential or mixed property will, by default, be characterized as commercial property. Property will be considered residential or mixed if any portion of the property is being used as a residence. If at the time of installation and placing in service of the system the property is not occupied, then property will be considered residential or mixed if any portion of the property is intended for use as a residence. If property is used to regularly furnish lodging to transients for consideration, in which the rooms, apartments, suites, or the like are occupied by a transient for less than one hundred eighty consecutive days for each letting, then the property will be considered commercial property to the extent of that use.

Example 12:

Same facts as Example 1. Since the unoccupied homes being built by the developer are intended for use as single-family residences, a claim for the credit based upon the installation and placing of service of a photovoltaic system on one of the homes will be subject to the single-family residential property cap.

Example 13:

Taxpayer leases property to tenants for residential use. Even though the taxpayer is engaged in the commercial activity of renting property, the character of the property is determined by its use as a residence. A system installed and placed in service by the taxpayer for this rental property will be subject to the single-family or multi-family residential property limitations.

Example 14:

A hotel, or any other place in which lodgings are regularly furnished to transients for consideration, in which all of the rooms, apartments, suites, or the like are occupied by a transient for less than one hundred eighty consecutive days for each letting will be considered commercial property.

The number of separate residences located on a single property will determine whether the property is considered single-family residential property or multi-family residential property. A single property consisting of more than one residence will be considered multi-family residential property. The determination that property is multi-family residential property is fact specific; but, in general and in the absence of other relevant facts to the contrary, multi-family residential property will be real property that is described in a recorded title and that has more than one mailing address or separate entrances to separate living areas. However, two exceptions will be made:

The Ohana House Exception: If a single property has two separate residences, each occupied by members of a family as defined in the Internal Revenue Code, § 267(b)(1), then each residence will be considered a separate single-family residential property if the system services both residences. Internal Revenue Code, § 267(b)(1) states that "members of a family" are as defined in subsection (c)(4). Subsection (c)(4) states that "[t]he family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendents."

The Directed Use Exception: If a system only services one residence on a multi-family residential property, then the system will be treated as servicing a single-family residential property.

Example 15:

A taxpayer installs and places in service a renewable energy technology system that services a building containing 50 condominium units used commercially and 50 condominium units used as single-family residences. Each unit is titled separately, therefore, each unit would be considered a separate property. If the system serviced only one condo unit, the appropriate property limit would apply, which under the facts of this example would be either the single-family residential property limit or the commercial property limit. This is not an example of the Directed Use Exception.

On the other hand, if the building did not consist of separately titled condominium units, but instead was an apartment complex with 50 apartment units used commercially and 50 apartment units used as single-family residences, then a system installed to service just one apartment unit used as a residence would be subject to the single-family residential property limit notwithstanding the fact that the apartment unit is part of a multi-family residential property. This is an example of the Directed Use

Exception. If the system in this hypothetical involving the apartment complex serviced two apartment units used as residences instead of one, then the multi-family residential property limit would apply using only the number of serviced units, not the total number of units in the entire apartment complex.

E. Mixed-Use Property versus Multiple Properties

A renewable energy technology system can be installed and placed in service for more than one property or where a single property is used as a residence and for commercial purposes. It is important to keep in mind that the treatment of mixed-use property is different than that for a system servicing multiple properties. In both situations, though, the department requires that the taxpayer consistently apply a reasonable allocation method, such as square footage or a measure of use.

In situations where one property has more than one use, the actual cost of the system is allocated between the residential use (which may be single-family use or multiple-family use) and the commercial use. Assuming the system in question is a photovoltaic energy system, thirty-five percent of the cost allocated to residential use is compared against either the single-family residential cap or the multiple-family residential cap; and thirty-five percent of the cost allocated to commercial use is compared against the commercial property cap.

Example 16:

Taxpayer has designated one room of her residence for use as a home office, which is recognized as such by the IRS for federal tax purposes. For purposes of this tax credit, the property will be considered a mix of residential and commercial property. If an allocation by square footage is used and the home office constitutes 5% of the total square footage, then a $20,000 photovoltaic energy system would result in the following credit:

Single-family residential: The allocated cost is 95% of $20,000, or $19,000. 35% of the allocated cost ($19,000) is $6,650. Then compare to the cap for single-family residential property, which is $5,000. The credit associated with the residential portion of the property is $5,000.
Commercial: The allocated cost is 5% of $20,000, or $1,000. 35% of the allocated cost ($1,000) is $350. Then compare to the cap for commercial property, which is $500,000. The credit associated with the commercial portion of the property is $350.

The total credit for the $20,000 system is the residential portion ($5,000) plus the commercial portion ($350) for a total credit of $5,350.

Example 17:

Taxpayer is a farmer and has a dwelling and barn on one of her lots. Following the definition of property set forth in this TIR, the particular lot containing both the dwelling and the barn would be considered a mixed-use property. If taxpayer installs and places in service a renewable energy

technology system that only services the barn, then an allocation by use would result in the system subject only to the commercial property limitations. (Note: This is not an example of the directed use exception discussed above; an allocation would still be made, but it would be a 0% residential/100% commercial allocation based upon use.) Likewise, if the system only serviced the single-family dwelling, then an allocation by use would result in the system subject only to the single-family residential property limitations. If the system serviced both the barn and the dwelling, then a portion of the system's actual cost would be subject to the commercial property limitations and the rest would be subject to the single-family residential property limitations.

Example 18:

Taxpayer installs and places into service a renewable energy technology system for an apartment complex that contains both residential and commercial units. Each unit is not separately titled, so each unit would not be treated as separate property. Instead, the titled property is the entire apartment complex. Since the titled property is mixed-use, the taxpayer will have to reasonably allocate the actual cost of the system between the residential and commercial uses of the property. Assuming 50 residential apartment units and 10 commercial units of equal size and use, and a $600,000 photovoltaic energy system, the credit would be calculated as follows:

Allocation of cost: The actual cost of $600,000 would be divided between residential use of the property and the commercial use of the property, allocating $500,000 to the residential use and $100,000 to the commercial use.

Residential Use: Since the property contains more than one residence, the proper characterization of this use is multi-family residential. In this case, thirty-five percent of $500,000, or $175,000, would be compared against the $350 per unit multi-family residential property cap, or $17,500. Under the facts of this example, the multi-family residential use of the property would generate a $17,500 credit (50 units times $350).

Commercial Use: In this case, thirty-five percent of $100,000, or $35,000, would be compared against the $500,000 commercial property cap. Under the facts of this example, the commercial use of the property would generate a $35,000 credit.

The total credit for the $600,000 photovoltaic energy system is $52,500.

A different calculation is required for a system that services more than one property. As with a mixed-use property, the actual cost of a single system servicing multiple properties is allocated among the properties. The difference lies with the application of the cap. With a

mixed-use property, the cap is applied once to each use since it is a single property. With multiple properties, the appropriate cap is applied for each separate property.

Example 19:

Taxpayer installs and places into service a wind farm that services one community of 50 single-family homes and 10 separate commercial properties. Assuming that each property is equal in size and use, the allocation of the actual cost would be made equally to each property. If a $600,000 wind-powered system were installed and placed in service for these properties, the credit would be calculated as follows:

Allocation of cost: The actual cost of $600,000 would be divided equally among the properties, allocating $10,000 to each property.

Single-family residential: Each single-family residential property would be treated independently. In each case, twenty percent of $10,000, or $2,000, would be compared against the $1,500 single-family residential property cap. Under the facts of this example, each single-family residential property would generate a $1,500 credit, for a total of $75,000 (50 properties times $1,500).

Commercial: Each commercial property would be treated independently. In each case, twenty percent of $10,000, or $2,000, would be compared against the $500,000 commercial property cap. Under the facts of this example, each commercial property would generate a $2,000 credit, for a total of $20,000 (10 properties times $2,000).

The total credit for the $600,000 wind-powered system is $1,500 for each single-family residential property ($75,000) plus $2,000 for each commercial property ($20,000) for a total credit of $95,000.

Example 20:

Unlike Example 19, Taxpayer (for example, an independent energy provider or the local electricity provider) installs and places into service a wind farm that does not service any particular property, but is entirely directed into the energy grid of the local electricity provider. The renewable energy technology system will be considered to be servicing commercial property only; no allocation is necessary.

However, if an identifiable connection exists to any particular property in addition to a connection to the energy grid of the local electricity provider, then the cost of the system must be allocated among and between the particular property or properties being serviced and the connection to the energy grid, which is treated as servicing a single commercial property.

Example 21:

Taxpayer installs and places into service a renewable energy technology system for a condominium that contains both residential and commercial units. Each condominium unit has a separate title, so each unit would be treated as a separate property. The taxpayer will have to reasonably allocate the actual cost of the system between the residential and commercial properties. Assuming 50 single-family condominium units and 10 commercial units of equal size and use, and a $600,000 photovoltaic energy system, the credit would be calculated as follows:

Allocation of cost: The actual cost of $600,000 would be divided equally among the properties, allocating $10,000 to each property.

Single-family residential: Each single-family residential condo unit would be treated independently. In each case, thirty-five percent of $10,000, or $3,500, would be compared against the $5,000 single-family residential property cap. Under the facts of this example, each single-family residential property would generate a $3,500 credit, for a total of $175,000 (50 units times $3,500).

Commercial: Each commercial condo unit would be treated independently. In each case, thirty-five percent of $10,000, or $3,500, would be compared against the $500,000 commercial property cap. Under the facts of this example, each commercial property would generate a $3,500 credit, for a total of $35,000 (10 properties times $3,500).

The total credit for the $600,000 photovoltaic energy system is $3,500 for each single-family condo unit ($175,000) plus $3,500 for each commercial condo unit ($35,000) for a total credit of $210,000.

For more information, please contact Jason P. Healey, Administrative Rules Specialist at (808) 587-1562 or the Rules Office at (808) 587-1577.

Kurt Kawafuchi
Director of Taxation

HRS Sections Explained: HRS § 235-12.5.