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IRS Releases “Start Construction” Guidance for Renewable Energy Facilities

Long-awaited guidance regarding eligibility for production or investment tax credits largely tracks guidance under the Section 1603 cash grant program.

On April 15, the Internal Revenue Service (IRS) released Notice 2013-29 (Notice),[1] which provides taxpayers with guidance as to when construction will be deemed to have “started” for certain renewable energy facilities eligible for the production tax credit (PTC) or investment tax credit (ITC). In addition to these guidelines, the Notice provides a “safe harbor” that taxpayers may seek to fall within to obtain additional assurance of their eligibility for the PTC or ITC. Although the Notice closely tracks the Section 1603 start construction rules, developers of and investors in such renewable energy projects should be mindful of the slightly different requirements outlined below, particularly with respect to rules concerning “continuous construction,” to ensure that project construction is deemed to have “started” in 2013.

Background

The recently enacted American Taxpayer Relief Act of 2012 (commonly known as the “fiscal cliff bill”) provides that “qualified facilities” that produce certain energy from certain renewable sources are now eligible for the PTC or the ITC if “construction begins” on such facilities before January 1, 2014. Generally, such qualified facilities use the following renewable sources to generate energy: wind, biomass, geothermal, landfill gas, municipal solid waste, hydropower, and marine/hydrokinetic. Solar energy facilities continue to be eligible for a 30% ITC if they are placed in service by January 1, 2017, and are not impacted by the ITC or PTC provisions of the fiscal cliff bill.

Prior to the fiscal cliff bill, a qualified facility would be eligible for the PTC or the ITC (if an election is made to claim the ITC in lieu of the PTC) if it was “placed in service” prior to January 1, 2014 (January 1, 2013, in the case of “large” wind facilities). In addition to extending PTC and ITC eligibility through 2013 for qualifying wind facilities, the fiscal cliff bill relaxes tax credit eligibility for qualifying facilities by providing that construction on such facilities need only begin prior to January 1, 2014, and that the facilities do not have to be placed in service. Thus, the fiscal cliff bill effectively extends eligibility for other types of renewable energy projects (such as large-scale biomass facilities) that, because of long construction lead times, could not be placed in service during 2013. While the PTC and ITC provisions of the fiscal cliff bill were hard fought and welcomed by the renewable energy industry, it was unclear, prior to issuance of the Notice, as to what standards would be applied in determining when construction “started” on a qualified facility for the purpose of Section 45 or 48 of the Internal Revenue Code (Code).

Notice’s Tracking of Section 1603 Rules

As many practitioners expected, the IRS used the “start construction” rules applied in connection with the U.S. Department of the Treasury’s Section 1603 grants[2] as a framework for the PTC and ITC start construction

1. View Notice 2013-29 at http://www.irs.gov/pub/irs-drop/n-13-29.pdf.

2. Section 1603 of the American Recovery and Reinvestment Tax Act of 2009 authorized the Treasury to make payments to eligible persons who placed in service “specified energy property” and applied for grants. These grant payments were payable in lieu of the PTC or ITC otherwise payable with respect to such energy property. As grants are only payable for projects placed in service or started between 2009 and 2011, the grant program is currently winding down.

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guidance. In fact, many key aspects of the Notice apply the Section 1603 start construction rules verbatim, with a few important differences. As under the Section 1603 rules, the Notice provides that construction has "started" for purposes of the PTC and ITC if the taxpayer demonstrates that it either (i) started physical work of a significant nature (the Physical Work Test) or (ii) incurred sufficient costs with respect to the facility over a specified threshold (the Safe Harbor).

Physical Work Test

One way that a taxpayer will be treated as having started construction on a qualified facility is if it begins physical work of a significant nature. Generally, work performed by the taxpayer itself, or by a contractor under a "written binding contract," may be taken into account for this purpose. Whether this work has "started" is based on a facts-and-circumstances analysis, and once started, the work must proceed under a continuous program of construction.

Using the same example provided for in the Section 1603 rules, the Notice describes which aspects of constructing a wind turbine facility will be treated as "significant" work if done by the taxpayer itself on-site. Excavation of the foundation, setting anchor bolts, or pouring concrete are all considered work of a significant nature. Where components manufactured off-site are assembled on-site, work is considered to have "started" when the components are manufactured off-site but only if done pursuant to a written "binding" contract (as discussed below). As under the Section 1603 rules, preliminary activities, such as studies, permitting, and clearing of existing facilities, are not considered work of a significant nature.

Where the work is performed for the taxpayer, the Notice largely mirrors the Section 1603 rules and provides that such work is taken into account only if it is performed under a written binding contract and the components constructed are custom-made and not "off the shelf" inventory held by the contractor. Where the contractor manufactures components for more than one facility, the Notice (unlike the Section 1603 rules) provides that a reasonable allocation method must be used to associate components with facilities. While the Notice provides that a contract is binding if it is enforceable under local law against the taxpayer and does not limit damages to a specified amount (e.g., via a liquidated damages provision), it does not go into the level of detail contained in the Section 1603 rules as to when a contract is considered binding. For example, the Section 1603 rules specifically state that, while certain minor changes do not affect the binding nature of a contract, options to purchase property and supply agreements that lack amounts and design specifications are not binding. The Notice, however, does not address these specific points. Finally, as under the Section 1603 rules, where components are manufactured under a master binding "frame" contract, work performed under the contract may be taken into account, even if the rights to certain components of the frame (and the associated contract rights and obligations) are ultimately assigned by the taxpayer to a special purpose vehicle.

One subtle difference between the Notice and the Section 1603 rules concerns the treatment of energy facilities comprised of severable generation units. Under the Notice, for the determination of whether construction has "started," the focus is on the entire project and not on the individual generation units or facilities that make up the entire project. Thus, for purposes of the PTC and ITC start construction rule, multiple facilities within a project are considered a single facility. This default rule is favorable to taxpayers, because, for example, once significant work begins on a single wind turbine, the taxpayer is considered to have started work on the entire wind farm, even if the taxpayer does not begin working on all turbines within the farm by year-end.[3] The Notice lists a series of factors that are relevant in determining whether multiple facilities are part of a single project, including common ownership of the facilities, location of the facilities, common agreements, and common connection infrastructure. By contrast, the Section 1603 default rule states that, for purposes of determining the start of construction, the components of a larger property are treated as a single unit of property independent of other units. For example, the components of a wind turbine (the fan, tower, and pad) are a single unit, and the wind turbine is separate from others on the farm. However, the vast majority of applicants took advantage of an election permitted under the Section 1603 rules to treat multiple units within a project as a single unit of property, and where fewer than all of the planned units were ultimately completed, an applicant could claim a grant based on the units actually placed in service. For example, the Section 1603 election allowed a developer to elect to treat a wind farm as a single

3. Historically, for purposes of the PTC, the IRS has considered each turbine within a project as a separate facility.

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unit, rather than claim a grant with respect to individual turbines, and the grant would be based on the number of turbines actually placed into service. In effect, the single unit treatment provided for by default in the Notice is consistent with the practical treatment allowed under the Section 1603 cash grant program and saves taxpayers the added step of having to make an affirmative election.

As is generally the case with the Section 1603 rules, the Notice provides that only work performed on property that is “integral” to the qualified facility is counted in determining whether construction has “started.” Property used to produce electricity is considered integral, but the property used for transmission of the electricity is not integral. Certain on-site roads may be considered integral if they are used in the operation and maintenance of the facility, but fencing and other buildings are generally not considered integral. Unlike the Section 1603 rules, however, the Notice does not go into specific detail as to what is considered an integral part of a qualified facility among the different categories of qualified facilities (such as what is an integral part of an “open-loop biomass” facility or a qualified property that generates electricity).

The Notice generally adopts the “continuous construction” standard for purposes of the Physical Work Test. Under this standard, only work performed under a program of continuous construction is taken into account for purposes of the test. However, the Notice provides greater clarity than the Section 1603 rules as to the relevant facts and circumstances used in a continuous construction analysis. The factors set forth in the Notice reflect a somewhat expanded set of permissible disruptions to a taxpayer’s construction program if they are outside the control of the taxpayer (such as weather conditions, permit delays, regulatory problems, certain litigation, and supply/labor shortages). The Section 1603 rules, on the other hand, merely provide that such disruptions would be taken into account as part of the overall application of the continuous construction standard. Of particular note is the Notice’s implication of a bright-line rule with respect to financing delays, explaining that delays of less than six months will be considered outside the control of the taxpayer. This would appear to prevent developers from placing projects started in 2013 on hold for more than six months while the developer seeks financing. A similar rule is applied with respect to the new “continuous efforts” requirement that is part of the Safe Harbor, as discussed below. Some practitioners believed that, under the Section 1603 rules, long financing delays could be permissible with the right set of facts under the continuous construction standard.

5% Safe Harbor

A taxpayer may alternatively rely on the Safe Harbor in determining whether it has “started” construction on a qualified facility. Under the Notice, if a taxpayer incurs (or is treated as incurring) 5% or more of the total cost of the facility and makes “continuous efforts” to advance toward completion of the facility, it has satisfied the Safe Harbor.

This Safe Harbor deviates from its Section 1603 counterpart in three ways. First, the cost threshold has been lowered to 5%, whereas the Section 1603 safe harbor requires expenditures of more than 5%. Second, and more importantly, the Notice imposes a “continuous efforts to completion” requirement, which is not required under the Section 1603 safe harbor. As with the “continuous construction” standard applied for purposes of the Physical Work Test, whether the taxpayer has made “continuous efforts to advance completion of the facility” is a facts-and-circumstances analysis. In this regard, the Notice sets forth several facts that indicate that such efforts have been made, including paying or incurring additional amounts included in the cost of the facility, entering into binding contracts for components or future work, and performing physical work of a significant nature. Also, as is the case under the Physical Work Test, certain disruptions outside the control of the taxpayer are not considered indications the taxpayer has failed the “continuous efforts” requirement. As discussed above, the Notice provides that financing delays of less than six months are not deemed to be within the taxpayer’s control, which again prevents developers from incurring 5% of total costs and subsequently allowing the project to linger while financing is sought (a common fact pattern for Section 1603–funded projects). Only time will tell as to whether the Safe Harbor’s “continuous efforts to completion” standard will be interpreted more liberally in practice by the IRS than the Physical Work Test continuous construction standard. It is clear, however, that the new Safe Harbor standard makes the Safe Harbor less objective than the corresponding Section 1603 rule. Finally, as compared to the Section 1603 rules, the Notice provides additional, clearer detail with respect to cost overruns on single facilities not comprised of multiple facilities, as discussed below.

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Aside from the slightly lower cost threshold and the continuous efforts requirement, the Safe Harbor generally follows the Section 1603 safe harbor requirements. For instance, the 5% threshold is based on the total costs of the facility included in the depreciable basis of the facility, and costs incurred by a contractor under a binding written contract may be deemed paid by the taxpayer when incurred by the contractor under tax accounting principles. Also, with respect to cost overruns, the Notice adopts the approach taken by the Section 1603 rules by providing that, if actual amounts paid with respect to the facility are such that the amounts incurred prior to January 1, 2014, are less than 5%, the Safe Harbor is **not** fully satisfied. However, in such a case, the PTC or ITC may be claimed with respect to some, but not all, of the individual facilities making up the total project, so long as the cost of the individual facilities is not more than 20 times the costs incurred prior to January 1, 2014. The Notice provides the example of a taxpayer that incurs $25,000 of costs in 2013 to produce a five-turbine wind farm, with the expectation that the total cost of the farm would be $500,000 and that each turbine would be $100,000, but actual amounts paid equal $600,000 ($120,000 per turbine). While the taxpayer in the example does not incur 5% of the actual $600,000 paid, the taxpayer does satisfy the Safe Harbor with respect to four of the five turbines, as the $480,000 spent on four of the turbines is not more than 20 times greater than the $25,000 spent in 2013. The Notice highlights in the example that, while the Safe Harbor is not met with respect to all five turbines, the entire wind farm of five turbines could potentially satisfy the Physical Work Test.

As noted above, the Notice also provides that, where cost overruns result in less than 5% of the total cost being paid prior to January 1, 2014, for a single facility that is not composed of and not divisible into smaller facilities, the taxpayer does not satisfy the Safe Harbor for **any portion** of the facility. Thus, where there is a cost overrun for a single, indivisible property, the taxpayer may be forced to qualify for the PTC or ITC by satisfying the Physical Work Test. The following example of this rule is provided in the Notice: A taxpayer incurs $25,000 in 2013 to construct an open-loop biomass facility (consisting of a boiler and generator that are functionally interdependent) with planned costs of $500,000, but actual costs paid equal $600,000. Since the boiler and generator are treated as a single facility due to their functional interdependence, the biomass facility cannot be broken down into multiple facilities, and the taxpayer fails to meet the Safe Harbor (as it spent less than 5% in 2013 of the $600,000 total spent on the facility). In this instance, the taxpayer would be forced to meet the Physical Work Test in order to claim the PTC or ITC for the facility.

Implications

The Notice provides helpful guidance with respect to obtaining tax credit eligibility for certain renewable energy projects. Similar to what occurred in 2011 as a result of the start construction deadline contained in the Section 1603 rules, there is likely to be significant development activity in 2013, as developers and investors strive to obtain tax credit eligibility for the above discussed renewable energy projects. However, developers and investors should carefully consider the slightly different “start construction” requirements contained in the Notice, particularly with respect to the continuous construction standard applicable to the Physical Work Test and the similar “continuous efforts” requirement applicable to the Safe Harbor.

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