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Start-Of-Construction Update Should Benefit Clean Energy

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On May 5, 2016, the U.S. Internal Revenue Service released Notice 2016-31[1] (available here) to update previous IRS "start of construction" guidance in light of the extension (at the end of 2015) of the renewable electricity production tax credit (PTC) under Section 45 of the Internal Revenue Code of 1986, for electricity produced by qualifying wind, hydropower, geothermal, biomass or trash projects (PTC projects) that begin construction before 2017, and a gradually phased out PTC in the case of qualifying wind facilities that begin construction after 2016 but before 2020.[2]

It is our impression that the industry reaction to the notice has been favorable, with the most significant aspect of the notice being that it makes it easier for developers to establish satisfaction of the IRS' requirement of continuous progress toward completion of a project so as to avoid the risk of an "after-the-fact" denial of PTCs despite having actually started construction by the deadline under Section 45 of the Internal Revenue Code.

Background

On Dec. 18, 2015, President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015,[3] which extended the full PTC (and investment tax credit, or ITC, in lieu of the PTC) to PTC projects that begin construction before Jan. 1, 2017. The act also extended and gradually phased out the PTC (and ITC in lieu of the PTC) for qualifying wind facilities that begin construction after 2016 but before 2020. Prior to the extension under the act, the PTC and ITC in lieu of the PTC were available for energy produced by PTC projects only if construction of the facility began before Jan. 1, 2015. The act also extended the ITC for solar energy facilities that begin construction before Jan. 1, 2022, prior to which the cutoff date was Jan. 1, 2017.

The full PTC is generally an amount equal to the product of 1.5 cents multiplied by the kilowatt hours of electricity produced by the taxpayer and sold to an unrelated person, adjusted for inflation (which for 2016 results in a credit rate of 2.3 cents), and is available during the 10-year period beginning on the date the facility was originally placed in service. In the case of qualifying wind facilities, the amount of the credit is reduced by 20 percent for facilities that begin construction during 2017, by 40 percent for facilities that begin construction during 2018 and by 60 percent for facilities that begin construction during 2019. The same percentage reduction applies if the owner of a qualifying wind facility elects the ITC in lieu of the PTC.

There was existing guidance, in the form of a series of notices issued by the IRS,[4] that clarified the circumstances under which construction of a facility was deemed to have begun for purposes of establishing that the start-of-construction requirement was satisfied. The first of these notices, Notice 2013-29 (available here) (which was issued when the deadline for starting construction was Dec. 31, 2013) provides that a taxpayer can establish that construction has begun by starting physical work of a significant nature prior to Jan. 1, 2014 (the “physical work test”), or by paying or incurring at least 5 percent of the total cost of the facility before Jan. 1, 2014 (the “5 percent safe harbor”).

In addition, Notice 2013-29 effectively imposes a requirement that a project owner continuously progress a project toward completion once construction has begun (the “continuity requirement”). The continuity requirement is described as discretionary under Notice 2013-29 and is technically not a statutory requirement. Notice 2013-29 describes the continuity requirement as effectively a “look-back” rule allowing the IRS discretion to determine that the start-of-construction requirement was not satisfied if the IRS determines that the continuity requirement was not satisfied. Nonetheless, as a practical matter, the need for certainty as to the availability of PTCs in transactions financed with tax equity has effectively resulted in the continuity requirement being viewed as a substantive requirement.

The specific requirements for satisfying the continuity requirement depend on whether the taxpayer establishes start of construction under the physical work test or the 5 percent safe harbor. In the case of the physical work test, the taxpayer is required to maintain a continuous program of construction that involves continuing physical work of a significant nature. Under the 5 percent safe harbor, the taxpayer is required to make continuous efforts to advance toward completion of the project. In either case, under Notice 2013-29, the determination is based on the “relevant facts and circumstances.”[5]

Subsequently, in reaction to industry comments regarding the uncertainty of the “facts and circumstances” determination, the IRS issued Notice 2013-60 (available here), to add a safe harbor (the “continuity safe harbor”) pursuant to which the continuity requirement is deemed satisfied if the facility is placed in service before Jan. 1, 2016. The Jan. 1, 2016, date reflected a deadline to start construction prior to Jan. 1, 2014, under Section 45 of the code (i.e., a two-year period from the statutory start-of-construction deadline); this deadline was subsequently pushed out a year (i.e., requiring a project to be placed in service before Jan. 1, 2017) pursuant to Notice 2015-25 to reflect the one-year extension of the deadline to start construction enacted under the Tax Increase Prevention Act of 2014.[6]

The Notice

Notice 2016-31 provides the needed updates to the prior guidance to reflect the extensions to the PTC made by the PATH Act. While the act also provides for extension of the ITC for solar projects that start construction prior to Jan. 1, 2022, this aspect of the legislation is not addressed in the notice, other than to indicate that the Treasury and the IRS expect to issue separate guidance to address the ITC extension. With respect to the PTC extension, the notice makes it easier for projects to satisfy the continuity requirement by (1) significantly extending the time frame by which a project must be placed in service for the project to be eligible for the continuity safe harbor and (2) expanding the list of excusable disruptions that would otherwise interfere with satisfaction of the continuity requirement under a “facts and circumstances” determination.

In addition, the notice clarifies the prior guidance regarding the “single facility” rule for multiple “facilities” that operate as a “single project” and provides guidance regarding retrofitted facilities.

Significant Extension of the Continuity Safe Harbor

The notice significantly extends the continuity safe harbor such that a project is deemed to meet the continuity requirement if the project is placed in service by Dec. 31 of the year that includes the fourth anniversary of the date of the start of construction. To illustrate, the notice describes a facility for which construction begins on Jan. 15, 2016, and states that it will be considered to satisfy the continuity safe harbor if it is placed in service by Dec. 31, 2020.

While this expansion provides developers with a longer time period to complete construction of a project than under the prior guidance (which was generally two years), it does not change the deadline for starting construction in order to qualify for the full PTC or for determining the applicable level of reduced PTC. Thus, to receive the full PTC (i.e., without a phaseout), taxpayers will have to begin construction of projects (either through the physical work test or the 5 percent safe harbor) before the end of this year.

Prior to the issuance of the notice, there had been a great deal of speculation in the industry regarding how the IRS would address the interplay between the continuity safe harbor and the phaseout of the PTC for wind facilities — an issue often referred to as "vintaging." For example, assume that the continuity safe harbor continued to be two years (as under the prior guidance), an eligible wind facility that commenced construction during 2016 and was placed in service during 2019 might not satisfy the continuity requirement, whereas a facility that started construction during 2017 and was placed in service during 2019 would satisfy the continuity safe harbor and, therefore, would be entitled to the 20 percent reduced PTC. The question would be whether the facility that commenced construction in 2016 should be denied PTCs altogether or be entitled to the 20 percent reduced PTC, as if it had commenced construction in 2017.

The apparent inequities in each approach led many to speculate about ways in which the IRS might extend the time period for completing construction. The exact rationale for the four-year period set forth in the notice is unknown, but it may reflect the IRS' belief that the benefit to all taxpayers of the generous four-year period far outweighs any relative inequities.

Start Date of the Continuity Safe Harbor

In what appears to be an attempt to head off gamesmanship with respect to the application of the four-year continuity safe harbor, the notice provides that a project "may not rely upon the physical work test and the 5 percent safe harbor in alternating calendar years." For instance, a project owner that started physical work in 2016, and thus had until Dec. 31, 2020, to place the project in service, may not then in 2017 incur 5 percent of the cost of the project and take the position that it has until Dec. 31, 2021, to place the project in service and still have the benefit of the continuity safe harbor.

The need for this anti-abuse rule is not entirely clear. The notice illustrates this rule with an example in which a project satisfied the physical work test in 2015 and then satisfied the 5 percent safe harbor in 2016. The example concludes that the project must be placed in service by the end of 2019 to satisfy the continuity safe harbor; whereas, if the taxpayer had not started construction in 2015, the taxpayer would have had until the end of 2020 to place the project in service and still have the benefit of the continuity safe harbor. It is possible that this rule was intended not to police abuse, but as a (somewhat arbitrary) counterbalance to the generous four-year continuity safe harbor.

As a practical matter, this means that where the start-of-construction date may be unclear, developers are advised to take the conservative approach and plan to place the project in service by the end date to be eligible for the continuity safe harbor assuming the earliest possible start-of-construction date. For example, developers that rushed to perform physical work at the end of 2015, may be tempted to satisfy the 5 percent safe harbor in 2016 due to uncertainty whether the physical work performed at the end of 2015 satisfied the physical work test or because of the historic preference of tax equity investors for the 5 percent safe harbor. While it is advisable for them to do so as a protective measure notwithstanding the notice, the important takeaway from the notice, though, is that the conservative approach would be to make sure that the project is placed in service by the end of 2019 in case the IRS were to determine that construction in fact had started in 2015. For those developers that are less risk averse, they should be aware that risk-averse tax equity investors likely will require developers that want to use the full four-year window (i.e., a placed-in-service date by the end of 2020) to represent that they did not start construction prior to Jan. 1, 2016.

Although satisfaction of the continuity safe harbor provides developers and taxpayers with the most certainty regarding satisfaction of the continuity requirement, it should be noted, as discussed immediately below, that the Notice has made it easier for a project to satisfy the continuity requirement under the facts and circumstances determination.

Satisfying the Continuity Requirement Based on Facts and Circumstances

As noted above, in addition to the continuity safe harbor, Notice 2013-29 provided that a taxpayer may satisfy the continuity requirement based on all the “relevant facts and circumstances” (i.e., construction could extend beyond the continuity safe harbor period if the taxpayer can demonstrate the construction was in fact continuous). Notice 2013-29 further provided a nonexclusive list of excusable disruptions in the taxpayer’s construction of a facility that will not be considered as indicating that a taxpayer has failed to maintain a continuous program of construction. The notice adds additional excusable disruptions to the list, including interconnection-related delays, such as those relating to the completion of construction on a new transmission line or necessary transmission upgrades to resolve grid congestion issues, and delays in the manufacture of custom components. The notice also expands some of the already-listed excusable disruptions, including by broadening certain safety-related delays to include all matters of safety, not just public safety, and by eliminating the no more than six-month limitation on financing delays. As with Notice 2013-29, the list of excusable disruptions provided by Notice 2016-31 continues to be nonexclusive.

While the expansion of the list of excusable disruptions should make it easier for a project to satisfy the continuity requirement under a facts and circumstances determination, developers should continue to keep, and require third-parties to provide, detailed and regular documentation (e.g., monthly logs, regular third-party reports) that evidence a continuous program of construction (in the case of the physical work test) and/or continuous efforts to advance toward completion of the project (in the case of the 5 percent safe harbor). The IRS’ strict application of the start of the four-year continuity safe harbor, as discussed above, further underscores the need for such documentation to mitigate the risk that completion of the project may slip beyond the anticipated completion date.

Physical Work Test

As noted above, under Notice 2013-29, the physical work test requires “physical work of a significant nature.” As an example of “physical work of a significant nature,” Notice 2013-29 provided that, in the case of a wind turbine, on-site physical work of a significant nature begins with the beginning of the excavation for the foundation, the setting of anchor bolts in the ground, or the pouring of the concrete pads of the foundation. Notice 2014-46 clarified that this test focuses on the nature of the work performed, not the amount or cost. To illustrate activities that constitute "physical work of a significant nature," Notice 2014-46 provided a nonexclusive list of activities that included (1) the beginning of the excavation for the foundation, the setting of anchor bolts in the ground, or the pouring of the concrete pads of the foundation, (2) performing physical work on a custom-designed transformer that steps up the voltage of electricity produced at the facility to the voltage needed for transmission and (3) starting construction on roads that are integral to the facility.

Notice 2016-31 confirms that the physical work test is satisfied with the performance of work of a significant nature, irrespective of the amount or value of the work performed. To illustrate physical work of a significant nature, the notice provides a nonexclusive list of qualifying activities that, with respect to wind facilities, includes only the beginning of the excavation for the foundation, the setting of anchor bolts in the ground, or the pouring of the concrete pads of the foundation. Although the notice does not reiterate the other examples included in Notice 2014-46, nothing in the latest notice suggests that the IRS is abandoning its earlier guidance. To the contrary, the notice expressly provides that the prior guidance continues to apply except as otherwise provided in Notice 2016-31. While the reason for the omission of the other examples in Notice 2014-46 was likely in the interest in brevity, it may be that as a matter of convenience the Service simply chose to illustrate "physical work of a significant nature" with the original example set forth in Notice 2013-29.

Multiple Facilities as a Single Project

In addition to making it easier for a project to satisfy the continuity requirement, Notice 2016-31 expands on the existing guidance in the prior guidance regarding multiple "facilities" that operate as a "single project." The prior guidance explained how to apply the beginning of construction rules to a "single project" in light of other IRS guidance,[7] predating the prior guidance described above, that viewed each turbine, or "facility," as a separate unit of property for federal income tax purposes. The concept of what constitutes a "single project" for purposes of start of construction is critical because each individual facility that is considered included within the scope of a single project will be considered to have the same beginning of construction date and will be entitled to tax credits based on that start-of-construction date.[8] For instance, for a project using the physical work test, this principle means that qualifying work performed with respect to a single turbine will be treated as establishing that start-of-construction date for the entire project. Similarly, under the 5 percent safe harbor, qualifying costs incurred with respect to a single turbine (or more likely a subset of the project's turbines) will be treated as satisfying the start-of-construction requirement for the entire project. The "single project" principle also makes it possible to build a large project in phases, and have all of the phases be treated as having started construction when construction commenced on the first phase for purposes of determining the level of tax credit eligibility.[9]

The general rule under Notice 2013-29 is that multiple facilities are considered a single facility for purposes of the start-of-construction rules if they are operated as a "single project," and this determination is made based on consideration of all the facts and circumstances.[10] The latest notice clarifies that the "single project" determination will be made in the year in which the last of the multiple facilities is placed in service. The new notice also clarifies that the timing of the "single project" determination for purposes of the start-of-construction date is distinct from the determination of the placed-in-service date for the individual facilities included in the project. Thus, in the case of a wind farm, the single-facility definition that applies for purposes of the start-of-construction rules under the prior guidance and the latest notice is not applicable to determine when the individual turbines in the project are considered placed in service.

Disaggregation

In addition to clarifying the "single-project" determination date, Notice 2016-31 resolves, in favor of the taxpayer, an issue of considerable doubt under the prior guidance regarding the scope of the "single-project" principle. As discussed above, under Notice 2013-29, it is clear that the "single-project" concept is intended to enable an entire project to "piggyback" on the work performed, or costs incurred, with respect to individual facilities that are operated as a "single project." That is, starting construction on a single turbine could satisfy the start-of-construction requirement for all of the turbines included in a project and thus qualify an entire project for PTCs. It was unclear, however, whether a single turbine within the project could disqualify an entire project. For example, if the 5 percent safe harbor was satisfied before the end of 2014 for a wind farm comprised of 50 turbines and only 40 of the turbines were placed in service by the end of 2016 (i.e., the then-applicable deadline to be eligible for the continuity safe harbor under the prior guidance), the concern would be that the failure of the 10 turbines to meet the continuity requirement might result in all 50 turbines being deemed not to have satisfied the start-of-construction requirement.

The latest notice provides a so-called "disaggregation" rule to address this situation. Under this rule, multiple facilities that are treated as a "single project" can be disaggregated for purposes of satisfying the continuity safe harbor. Simply stated, this means that satisfaction of the continuity requirement is not an "all-or-nothing" determination. Accordingly, in the above example, whether or not all 50 of the turbines meet the continuity requirement does not change the fact that the continuity safe harbor was satisfied for those 40 turbines that were placed in service during 2016, and consequently the 40 turbines will be eligible for PTCs. In addition, the notice explains that the remaining 10 turbines (in our example) could still satisfy the continuity requirement under a facts and circumstances determination.

Retrofitted Facilities

Finally, the notice clarifies the treatment of retrofitted facilities. A project must be originally placed in service (i.e., essentially be new) to be eligible for the PTC. The notice clarifies that a facility may qualify as originally placed in service even if it contains some used property, so long as the fair market value of the used property is not more than 20 percent of the facility's total value (i.e., the cost of the new property plus the value of the used property). The notice further clarifies that in the case of a "single project," the 80/20 rule is applied individually to the turbines comprising the single project, not the project as a whole. In other words, each individual turbine that satisfies the 80/20 rule can qualify for PTCs, and each individual turbine that does not satisfy the 80/20 rule cannot qualify for PTCs, regardless of whether all of the turbines or the project as a whole satisfies the 80/20 rule. The application of the so-called 80/20 rule to a project claiming PTCs comes as no surprise as the IRS in other guidance has indicated that the 80/20 rule would apply with respect to the requirement that a project must be originally placed in service to be eligible for the PTC.[11]

Industry Reaction

Our overall impression is that the wind industry is relieved to have been provided with a four-year window to complete construction of projects; in the long term, that window is likely to result in more projects being constructed with the associated increase in environmental and economic benefits. We expect that the latter portion of 2016 will be quite busy for developers and their advisers as developers endeavor to meet the start-of-construction rules for their projects in order to qualify for the full PTC. Further, once developers have satisfied that requirement, the four-year window will provide them with time to proceed at a more deliberate pace with respect to placing turbine orders and entering into construction and tax equity financing agreements. Such a window may enable developers to negotiate for more favorable terms with respect to those items than they have in recent history when there has been more of a race against the clock.

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[1] 2016-21 I.R.B. _ (updated in 2016-23 I.R.B. _ on May 18, 2016, to reflect technical revisions and provide additional language regarding the effective date of Notice 2016-31).

[2] The extension of the PTC (including the phaseout) also applies to an election of the energy investment tax credit (ITC) in lieu of the PTC under Section 48 of the Internal Revenue Code.

[3] Pub. L. No. 114-113, Div. Q, 129 Stat. 2242.

[4] See Notice 2013-29, 2013-1 C.B. 1082 ("Notice 2013-29"); Notice 2013-60, 2013-2 C.B. 431 ("Notice 2013-60"); Notice 2014-46, 2014-2 C.B. 520 ("Notice 2014-46"); Notice 2015-25, 2015-13 I.R.B. 814 ("Notice 2015-25").

[5] With respect to the 5 percent safe harbor, Notice 2013-29 provided the following list of nonexclusive facts and circumstances that indicate continuous efforts to advance towards completion of a project: (a) paying or incurring additional amounts included in the total cost of the facility, (b) entering into binding written contracts for components or future work on construction of the facility, (c) obtaining necessary permits and (d) performing work of a significant nature. Given the four-year continuity safe harbor, there is less motivation for developers to pursue a 5 percent safe harbor strategy in order to be under the more lenient "continuous efforts" standard, rather than the "continuous construction" standard applicable to the physical work test.

[6] Pub. L. No. 113-295, 128 Stat. 4021. At the time that Notice 2013-29, Notice 2013-60 and Notice 2014-46 were each issued, construction of a project was required to have begun before Jan. 1, 2014, to be eligible for the PTC or ITC in lieu of the PTC. At the end of 2014, the PTC and ITC in lieu of the PTC were extended by a year, such that a qualifying project that began construction before Jan. 1, 2015, would be eligible for the PTC or ITC in lieu of the PTC. Notice 2015-25 updated Notice 2013-29, Notice 2013-60 and Notice 2014-46) to the extent necessary to reflect the extended deadline for starting

construction, including by providing a corresponding one-year extension of the placed-in-service deadline to be eligible for the continuity safe harbor.

[7] See Rev. Rul. 94-31, 1994-1 C.B. 16.

[8] To be clear, and as discussed in greater detail below, the “single-facility” concept applies only for purposes of determining whether construction of a project has begun. It does not apply for purposes of determining what constitutes a “facility” for purposes of the placed-in-service date.

[9] “Phases” is an industry term, rather than nomenclature used in the prior guidance or Notice 2016-31.

[10] While Notice 2013-29 had generally provided that whether multiple facilities will be treated as a “single project” will depend on the relevant facts and circumstances, it also specifically identified eight nonexclusive factors that indicate the multiple facilities are operated as part of a “single project.” The factors included: (a) The facilities are owned by a single legal entity, (b) the facilities are constructed on contiguous pieces of land, (c) the facilities are described in a common power purchase agreement or agreements, (d) the facilities have a common intertie, (e) the facilities share a common substation, (f) the facilities are described in one or more common environmental or other regulatory permits, (g) the facilities were constructed pursuant to a single master construction contract and (h) the construction of the facilities was financed pursuant to the same loan agreement. Some of the factors did not apply to certain projects. For instance, a “merchant” project would not have a common power purchase agreement or an equity financed project would not have a common construction loan. The new notice retains the language indicating that the “single-project” determination will depend on the relevant facts and circumstances; however, it does not identify any specific relevant factors. Nevertheless, nothing in the latest notice suggests that the IRS no longer considers the previously identified factors as factors indicating that multiple facilities are operated as part of a “single project” and, as previously noted, the notice expressly provides that the prior guidance continues to apply. Moreover, the IRS has informally confirmed that the eight factors enumerated in Notice 2013-29 continue to apply. While the omission of the eight factors from the new notice does not appear to signal that the IRS is taking a new approach to determining whether multiple facilities are operated as part of a “single project,” the casual omission of any specifically identified factors in the notice underscores the fact that the “single-project” determination under Notice 2013-29 was never intended to be interpreted as requiring the strict satisfaction of a set of prescribed factors.

[11] See Rev. Rul. 94-31, 1994-1 C.B. 16 (ruling that each wind turbine together with its tower and supporting pad is a separate “facility” for purposes of the PTC and a “facility” would qualify as originally placed in service even though it contains some used property, provided the fair market value of the used property is not more than 20 percent of the facility’s total value).