IRS Provides Guidance on Beginning of Construction for Renewable Energy Projects

On April 15, 2013, the US Internal Revenue Service (the IRS) released Notice 2013-29[1] (the Notice) to provide additional guidance on the "beginning of construction" requirement to qualify for the Section 45 production tax credit (the PTC), as well as the election to claim the Section 48 investment tax credit (the ITC).

Background

The American Taxpayer Relief Act of 2012[2] (the 2012 Act) changed the requirement under Section 45 that *a facility be placed in service before January 1, 2014* with the requirement that *construction of the facility must have begun before January 1, 2014*. This modification applies to wind, closed-loop biomass, open-loop biomass, geothermal energy, landfill gas, municipal solid waste, qualified hydropower and marine and hydrokinetic facilities that claim the PTC under Section 45, or that instead elect to claim the ITC under Section 48(a)(5). Prior to the 2012 Act, which also provided a one-year extension of the sunset date for the PTC for wind facilities, a wind facility had to be placed in service before January 1, 2013.[3]

The begun construction requirement is similar to the requirement under the US Treasury Department's (Treasury) Section 1603 cash grant program (the Grant Program), which required construction of a facility to have begun during 2009, 2010 or 2011. Accordingly, the Notice largely adopts the rules for the beginning of construction that were used by Treasury in the Grant Program.[4]

The Notice provides for two alternative methods to establish that construction of a qualified facility has begun: (i) starting physical work of a significant nature (the physical work method) or (ii) meeting the 5 percent safe harbor (the 5% safe harbor). Although many of the details in applying these two methods are the same as the Grant Program, there are some differences and some additional guidance in the Notice.

Physical Work Method

Under the physical work method, construction of a qualified facility begins when physical work of a significant nature begins. On-site and off-site work performed by either the taxpayer or another person under a binding written contract may be taken into account to demonstrate that this method has been met.

The Notice lists the following examples of what constitutes on-site physical work in the case of a wind facility: the beginning of the excavation for the foundation, the setting of anchor bolts into the ground or the pouring of concrete pads of the foundation. If the wind facility's turbines and towers are to be assembled on-site from components manufactured off-site by a person other than the taxpayer, physical work of a significant nature begins when the manufacture of components begins at the off-site location, but only if the manufacturing is done pursuant to a

binding written contract and the components are not held in the manufacturer's inventory.

Physical work does not include preliminary activities, such as planning or designing, securing financing, exploring, researching, obtaining permits, licensing, conducting surveys, environmental and engineering studies, clearing a site, test drilling of a geothermal deposit, test drilling to determine soil condition or excavation to change the contour of the land.

Work to produce property (by the taxpayer or by another person under a binding written contract) that is either in existing inventory or normally held in inventory by a vendor will not be considered physical work.

BINDING WRITTEN CONTRACT

Work performed under a binding written contract with respect to property that is manufactured, constructed or produced for the taxpayer by another person will be taken into account in determining when physical work of a significant nature begins, provided the contract is entered into before the work commences.

The Notice defines a binding written contract as one that is enforceable under local law against the taxpayer or predecessor and "does not limit damages to a specified amount (for example, by use of a liquidated damages provision)." The Notice does not include the additional language from the Grant Program guidance that "a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount."[5] Clarification is being sought from the IRS on whether this omission was deliberate or was an oversight.

MASTER CONTRACT

The Notice also allows the use of a master contract in a manner that is similar to the Grant Program. If a taxpayer enters into a binding written contract for a specific number of components to be manufactured, constructed or produced for the taxpayer by another person (a master contract), and then through a new binding written contract (a project contract), the taxpayer assigns its rights to certain components to an affiliated special purpose vehicle that will own the facility for which such property is to be used, work performed under the master contract may be taken into account in determining when physical work of a significant nature begins with respect to the facility.

PROPERTY INTEGRAL TO THE FACILITY

Physical work of a significant nature counts only when performed with respect to tangible personal property and other tangible property used as an "integral part" of the activity performed by the facility. This includes property integral to the production of electricity but not property used for electrical transmission. Roads (other than onsite roads used for moving materials to be processed or roads for equipment to operate and maintain the facility), fencing and buildings are generally not treated as integral to the facility.

CONTINUOUS CONSTRUCTION

As with the Grant Program, the Notice requires that, under the physical work method, there must be a "continuous program of construction" that involves physical work of a significant nature, as determined by the relevant facts and circumstances. The Notice states that certain disruptions that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to maintain a continuous program of construction. The Notice goes beyond the guidance for the Grant Program by listing the following examples of such disruptions:

- Severe weather conditions;
- Natural disasters;
- Licensing and permitting delays;
- Delays at the written request of a state or federal agency regarding matters of safety, security or similar concerns;
- Labor stoppages;

- The inability to obtain specialized equipment of limited availability;
- The presence of endangered species;
- Financing delays of less than six months; and
- Supply shortages.

5% Safe Harbor

Under the 5% safe harbor, construction of a facility will be considered as having begun before January 1, 2014, if (i) a taxpayer pays or incurs 5% or more of the total cost of the facility before January 1, 2014, and (ii) thereafter, the taxpayer makes continuous efforts to advance towards completion of the facility.

CONTINUOUS EFFORTS

Although the Grant Program does not include any requirement for continuous efforts under the 5% safe harbor, it is not open ended because of the placed-in-service deadlines for projects. Given that Section 45 no longer contains a placed-in-service deadline, the "continuous efforts" standard incorporated in the Notice presumably was intended to prevent the PTC (or ITC election) from being open ended. The Notice identifies a non-exclusive list of facts and circumstances that indicate such efforts:

- Paying or incurring additional amounts included in the total cost of the facility;
- Entering into binding written contracts for components or future work on construction of the facility;
- Obtaining necessary permits; and
- Performing physical work of a significant nature.

As with the physical work method, the Notice allows relief for certain disruptions that are beyond the taxpayer's control. It identifies the same examples of such disruptions as under the continuous construction requirement of the physical work method.

LOOK-THROUGH

For property that is manufactured, constructed or produced for the taxpayer by another person under a binding written contract with the taxpayer, costs incurred with respect to the property by the other person before the property is provided to the taxpayer are deemed incurred by the taxpayer when the costs are incurred by the other person under the principles of Section 461.

COST OVERRUNS

As with the Grant Program, if a taxpayer incurs cost overruns that otherwise would cause it to fail the 5% safe harbor, the Notice allows the taxpayer to essentially redefine the project (e.g., by including fewer wind turbines or solar arrays). However, the Notice clarifies that, if the taxpayer cannot redefine the project, no portion of the facility will satisfy the 5% safe harbor.

Facility

The Notice adopts the rule from Grant Program guidance that multiple facilities operated as a part of a single project will be treated as a single facility.[6] This is noteworthy because, in the case of a wind project, other IRS guidance requires that each turbine and its associated tower and supporting pad be treated as a separate facility.[7] The Notice goes further than the Grant Program guidance by listing the following factors that indicate whether multiple facilities are operated as part of a single project:

- The facilities are owned by a single legal entity;
- The facilities are constructed on a contiguous pieces of land;
- The facilities are described in a common power purchase agreement or agreements;
- The facilities have a common intertie;
- The facilities share a common substation;
- The facilities are described in one or more common environmental or other regulatory permits;

- The facilities were constructed pursuant to a single master construction contract; and
- The construction of the facilities was financed pursuant to the same loan agreement.

The Notice provides the following example to demonstrate application of these factors in the context of the physical work method:

> X is developing a wind farm that will consist of 50 turbines, their associated towers, their supporting pads, a computer system that monitors and controls the turbines, and associated power conditioning equipment. The entire wind farm will be connected to the power grid through a single intertie, and power generated by the wind farm will be sold to a local utility through a single power purchase agreement. In 2013, for 10 of the 50 turbines, X excavates the site for the foundations of the wind turbines and pours concrete for the supporting pads. Thereafter, X completes the construction of all 50 turbines and related facilities pursuant to a continuous program of construction (as determined under section 4.06). For purposes of sections 45 and 48, the entire wind farm is a single project that will be treated as a single facility, and X has performed physical work of a significant nature that constitutes the beginning of construction of that facility in 2013.

For more information about the matters raised in this Legal Update, please contact your regular Mayer Brown contact or the attorney listed below.

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Endnotes

1 2013-20 I.R.B. 1.

2 Pub. L. No. 112-240, 126 Stat. 2313.

3 See our prior Legal Update on the changes in the 2012 Act at: http://www.mayerbrown.com/Production-Tax-Credit-for-Wind-Energy-and-Bonus-Depreciation-Extended-Cuts-to-Section-1603-Cash-Grant-Program-Delayed-01-03-2013/.

4 See our prior Legal Update on the beginning of construction rules under the Grant Program at: http://www.mayerbrown.com/files/Publication/a9e48ca1-e71e-4cb2-ae01-58e2ff8a59c5/Presentation/PublicationAttachment/18d482f4-ce68-430e-a529-6e16748ad124/UPDATE-Tax_Trans_Construction_FAQ_0610_V2.pdf .

5 See our prior Legal Update on the binding written contract rules for the Grant Program at: http://www.mayerbrown.com/publications/US-Treasury-Revises-Cash-Grant-Program-Guidance-03-17-2010/.

6 See our prior Legal Update on this rule for the Grant Program at: http://www.mayerbrown.com/files/Publication/b3fba3fb-e14b-476b-bf3f-c8335aa28686/Presentation/PublicationAttachment/7c3bcc22-8647-4a92-8a3d-21e266f08699/UPDATE_Energy-Grants_0709_V3.pdf.

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