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McDermott: IRS Issues Additional Guidance With Respect to 2013 Beginning Of Construction Rules for Wind and Other Renewable Projects.

The Internal Revenue Service (Service) issued Notice 2014-46 (Notice) on August 8, 2014, to provide further guidance on meeting the beginning of construction requirements for wind and other qualified facilities (biomass, geothermal, landfill gas, trash, hydropower, and marine and hydrokinetic facilities). The Notice addresses the requirements of the physical work test and the transfer of a facility after construction has begun, as well as the five percent safe harbor.

Background

Section 407 of the American Taxpayer Relief Act of 2012 extended until January 1, 2014, the production tax credit (PTC) and the investment tax credit (ITC) for electricity produced from qualified facilities. Congress also liberalized the timing requirement for a qualified facility so that a taxpayer may meet the January 1, 2014, deadline by "beginning construction" on the facility by such date. Previously, a taxpayer could only meet the deadline by placing the facility in service.

The Notice clarifies and modifies two prior notices (Notices 2013-29 and 2013-60, both referred to herein as the Prior Guidance), providing taxpayers with initial guidance with respect to when construction will be considered to have begun in 2013 for purposes of the PTC and ITC. The Notice was issued in response to questions from industry participants and practitioners arising from the Prior Guidance.

Notice 2013-29

Under Notice 2013-29, a taxpayer may establish that construction has begun on a qualified facility by demonstrating that "physical work of a significant nature" has begun (Physical Work Test) or by satisfying a five percent safe harbor (Safe Harbor). Notice 2013-29 lists several examples of work that meets the Physical Work Test, including, with respect to a wind energy facility, the beginning of the exaction for the foundation, the setting of anchor bolts into the ground or the pouring of the concrete pads of the foundation. Both work completed onsite or off-site may be taken into account. The Service also imposed a requirement that a "continuous program of construction," as defined in the Prior Guidance (Continuous Construction Test), be maintained after performance of physical work in 2013.

The Safe Harbor set forth in Notice 2013-29 provides that the construction of a qualified facility is considered to begin before January 1, 2014, if a taxpayer pays or incurs (within the meaning of Treas. Reg. § 1.461-1(a)(1) and (2)) five percent or more of the total cost of the facility before such date. Thereafter, the taxpayer must make continuous efforts to advance toward completion of the facility (Continuous Efforts Test) to be deemed to have begun construction.

For more information on these tests and their requirements, see McDermott's Notice 2013-29 article.

Notice 2013-60

In September 2013, the Service issued Notice 2013-60, clarifying questions left outstanding by Notice 2013-29. [See McDermott's summary in its Notice 2013-60 article.] First, Notice 2013-60 provided that a facility will be considered to satisfy the Continuous Construction Test and the Continuous Efforts Test if it is placed in service before January 1, 2016. Second, Notice 2013-60 permitted a taxpayer to claim the PTC or ITC even if the taxpayer was not the owner of the facility on the date construction began.

Notice 2014-46

The Physical Work Test

One of the primary questions raised by industry participants and practitioners with respect to the Physical Work Test described in the Prior Guidance was how much physical work is required in 2013. This question arose, in part, due to an example in section 4.04(3) of Notice 2013-29, in which the taxpayer began construction on 10 of 50 planned wind turbines before January 1, 2014, and was deemed to have begun construction on the wind facility in 2013. The example implied to some that there was a 20-percent threshold on the amount of physical work that must be performed in 2013.

The Notice clarifies that the Physical Work Test focuses on the nature of the work performed rather than the amount or cost of such work. Citing the examples in section 4.02 of Notice 2013-29, it makes clear that these examples are a non-exclusive list of activities that would satisfy the Physical Work Test because they constitute physical work "of a significant nature." The examples include beginning of the excavation for the foundation for a wind turbine, the setting of anchor bolts into the ground or the pouring of the concrete pads of the foundation. Additionally, physical work on a custom-designed transformer meets the Physical Work Test because power conditioning equipment is an integral part of the activity performed by the facility. Lastly, starting construction on roads that are integral to the activity performed at the facility is an example of physical work of a significant nature. The Notice also clarifies that the example cited above relating to construction of 10 of 50 planned wind turbines in 2013 was not intended to indicate a 20-percent minimum threshold requirement to satisfy the Physical Work Test. As provided in the Notice, assuming the work performed is of a significant nature, there is no fixed minimum amount or work or monetary or percentage threshold required to satisfy the Physical Work Test.

The Notice focuses, therefore, on whether 2013 work is "significant," and implies that such work must be with respect to property that is "integral to the facility" to qualify. While the examples cited in the Prior Guidance and the Notice do not cover all of the types of physical work that were performed on development projects in 2013, the Notice's provisions do imply that, for example, the excavation of a single turbine foundation could be sufficient, so long as the Continuous Construction Test is met after 2013. Furthermore, that Continuous Construction Test might be met even if some turbine foundations are excavated in 2013 and then no activity occurs with respect to the project for some time, so long as the project is ultimately placed in service prior to January 1, 2016. In short, while not listing or defining all of the types of property that might be considered integral to a facility, the Notice makes clear that there is no threshold level of work that must have occurred in 2013 for construction to have begun.

Transfer of a Facility After Construction Has Begun

Notice 2014-46 also reiterates that the taxpayer who begins construction of a facility and the taxpayer who places it in service need not be the same person. However, the Notice adds a requirement to transfers to unrelated parties that mimics, although described in less detail in the

Notice, the requirements established by the U.S. Department of the Treasury (Treasury) in Frequently Asked Questions #23 and #24 in connection with the grant in lieu of ITC. More reading on those requirements can be found here.

The additional requirement added by the Notice is intended to prevent taxpayers from selling bare Safe Harbor-eligible equipment or equipment that met the Physical Work Test in 2013, as opposed to transferring entire projects that are in the development stages. The Notice provides that any amount paid by a transferor to an unrelated transferee in a transfer consisting solely of tangible personal property will not be taken into account with respect to the transferee for purposes of the Physical Work Test or Safe Harbor.

Thus, the Notice imposes two alternative requirements on transfers of projects to other parties. Either that party must be "related" under Internal Revenue Code Section 197(f)(9)(C) (which generally imposes a 20 percent ownership test) to the transferor, or the transfer must be of a project on which development has commenced. The Treasury's Frequently Asked Questions referenced above may provide some guidance to taxpayers, although they are not explicitly made applicable in the Notice, as to whether development has begun. Generally, development is evidenced by activity such as acquiring land, obtaining permits and licenses, entering into a power purchase agreement, entering into an interconnection agreement or contracting with an engineering, procurement and construction contractor.

The Notice also clarifies that a taxpayer may begin construction of a facility in 2013 with the intent to develop at a certain site, but thereafter transfer equipment and other components of the facility to a different site, and the work performed or amounts paid or incurred in 2013 can be taken into account for purposes of determining whether the facility meets the Physical Work Test or Safe Harbor.

The Five Percent Safe Harbor

According to Notice 2013-29, the Safe Harbor is not satisfied if the amount a taxpayer paid or incurred before January 1, 2014, with respect to the total cost of a facility that is a single project comprised of multiple facilities is less than five percent of the total cost of the facility at the time that it is placed in service. However, the Notice modifies this rule by providing that, if a taxpayer incurred at least three percent of the total cost of such a facility before January 1, 2014, the Safe Harbor may be satisfied with respect to some (although not all) of the individual facilities that are part of this larger project. A taxpayer may claim the PTC or ITC on the individual facilities if the aggregate cost of such facilities at the time the project was placed in service is not greater than 20 times the amount the taxpayer paid or incurred before January 1, 2014.

If, with respect to a single facility that cannot be separated into individual facilities, the amount the taxpayer paid or incurred before January 1, 2014, was less than five percent of the total cost of the facility at the time it was placed in service, then the taxpayer will not satisfy the Safe Harbor with respect to any portion of the facility.

The Notice provides examples of application of these rules that indicate that a wind turbine is considered a single facility, which has been previously confirmed in other guidance issued by the Service, and that a single boiler and turbine generator in a biomass project cannot be separated into multiple facilities.

Conclusion

The Notice clarifies several issues regarding the application of the Physical Work Test and Safe

Harbor. Probably most significantly, the Service has clarified that there is not a minimum amount of work required to satisfy the Physical Work Test, which may result in a fresh look at projects previously thought not to have met this test based on the amount of physical work performed in 2013.

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