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IRS Updates Start-Of-Construction Rule: Four Years For Project Completion.

On May 5, 2016, the US Internal Revenue Service released Notice 2016-31 (available here) (the "Notice"). The Notice updates previous guidance on satisfying the "start of construction" requirement to reflect the fact that wind, hydropower, geothermal, and biomass and trash facilities can now qualify for the full renewable electricity production tax credit ("PTC") under Section 45 of the Internal Revenue Code of 1986 (the "Code") (e.g., 2.3 cents per kilowatt) if construction starts before 2017 (or a reduced credit, if construction starts before 2020).

The Notice provides that the US Treasury Department and the IRS will issue separate guidance to address the application of these rules to solar energy facilities claiming the investment tax credit ("ITC") under Section 48 of the Code.

The basic rules regarding the "five percent safe harbor" and "significant physical work test" remain unchanged. The Notice provides projects with a four-year window for completion and provides additional guidance regarding multiple "facilities" that operate as a "single project."

Background

In the final days of 2015, the Consolidated Appropriations Act of 2016 (P.L. 114-113) (the "Act") extended the PTC to qualified facilities, such as wind facilities, that begin construction before January 1, 2020 (the previous expiration date was January 1, 2015). The Act also phased out the wind PTC, which generally is an amount equal to the product of 1.5 cents, adjusted for inflation (which, for 2016, results in a credit rate of 2.3 cents), multiplied by the kilowatt hours of electricity produced by the taxpayer and sold to an unrelated person, by providing that the amount of the credit shall be reduced by 20 percent for facilities that begin construction during 2017, 40 percent for facilities that begin construction during 2018 and 60 percent for facilities that begin construction during 2019. For a more detailed analysis of the Consolidated Appropriations Act of 2016, see our December 28, 2015, Legal Update).

Prior to the extension, the PTC was available for a qualified facility, such as a wind facility, only if construction of the facility began before January 1, 2015. The IRS also had issued guidance in the form of a series of notices (the "Prior Guidance") to clarify when construction of a facility was deemed to have begun.

Under Notice 2013-29 (available here), a taxpayer can establish that construction has begun by starting physical work of a significant nature prior to January 1, 2014 (the "Physical Work Test") or by paying or incurring at least five percent of the total cost of the facility before January 1, 2014 (the "Five Percent Safe Harbor"). In addition, under the Physical Work Test, the taxpayer is required to maintain a continuous program of construction, while the Five Percent Safe Harbor requires that the taxpayer make continuous efforts to advance toward completion of the facility (for a more detailed analysis of Notice 2013-29, see our April 16, 2013, Legal Update). Subsequently, in Notice 2013-60 (available here), the IRS clarified that the continuous program of construction and continuous efforts requirements would be deemed satisfied if the facility were placed in service before January 1, 2016 (the "Continuity Safe Harbor") (for more complete coverage of Notice 2013-60, see our September 23, 2013, Legal Update). In Notice 2014-46 (available here), the IRS further clarified and modified Notices 2013-29 and 2013-60 (for a discussion of Notice 2014-46, see our August 8, 2014, Legal Update). Finally, the IRS issued Notice 2015-25, which updated previously issued guidance to reflect the one-year extension of the PTC until December 31, 2014, including the extension of the date of the Continuity Safe Harbor to January 1, 2017 (for more complete coverage of Notice 2015-24, see our March 12, 2015, Legal Update).

Until the issuance of the Notice, there was uncertainty as to whether the Prior Guidance would continue to apply with respect to the five-year extension. Of particular concern was how the IRS would roll forward the date of the Continuity Safe Harbor in light of the multi-year extension and the phase-out of the PTC.

The Notice

Completion Window – Continuity Safe Harbor. Previously, Notice 2013-29 had imposed a requirement that a project owner continuously advance the construction of the project from the time construction starts through the placed-in-service date. In reaction to industry comments, the IRS had created the Continuity Safe Harbor in Notice 2013-60 to deem continuous construction to have occurred if the project was placed in service before January 1, 2016. The Notice significantly expands the Continuity Safe Harbor to deem a project to meet the "continuity" requirement if the project is placed in service by December 31 of the year that includes the fourth anniversary of the date of the start of construction. The Notice provides the following example in which "construction begins on a facility on January 15, 2016, and the facility is placed in service by December 31, 2020, the facility will be considered to satisfy the Continuity Safe Harbor."

To head off gamesmanship with respect to the application of the four-year rule, the Notice provides that a project "may not rely upon the Physical Work Test and the Five Percent Safe Harbor in alternating calendar years." For example, a project owner that started physical work in 2016, and thus had until December 31, 2020, to place the project in service, may not in 2017 incur five percent of the cost of the project and take the position that it has until December 31, 2021, to place the project in service. Thus, taxpayers are advised to carefully select the year in which a project satisfies the Physical Work Test or Five Percent Safe Harbor, although the four-year window for satisfaction of the Continuity Safe Harbor may take some pressure off this selection.

Completion Window – Facts and Circumstances. 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. Notice 2013-29 further provided a non-exclusive 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 and delays in the manufacture of custom components. The Notice also expands some of the already-listed excusable disruptions including by broadening safety related delays to include all matters of safety, not just public safety, and by eliminating the limitation of no more than six months on financing delays. As with Notice 2013-29, the list of excusable disruptions provided by the Notice continues to be non-exclusive.

Physical Work Test. Under Notice 2013-29, the Physical Work Test requires "physical work of a significant nature." 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 non-exclusive list of activities that included (i) 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, (ii) 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 (iii) roads that are integral to the facility.

The Notice 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 non-exclusive 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 Notice suggests that the IRS is abandoning its earlier guidance. On the contrary, the Notice expressly provides that the Prior Guidance continues to apply except as otherwise provided in the Notice.

Multiple Facilities as a Single Project. The Notice and the Prior Guidance apply the start-o--construction rules to a “project,” whereas other IRS guidance had viewed each turbine as a separate unit of property for federal income tax purposes. The definition of a single project is critical because whatever facilities are within the scope of a single project have the same start-o--construction date for purposes of determining the level of tax credits to which the project is entitled. For example, for a project using the Physical Work Test, this principle means the work need only occur with respect to the project generally and not with respect to each turbine.

The single project principle also makes it feasible to have a project built in large phases and have all of the phases have a common start-of-construction date for purposes of determining the level of tax credit eligibility.1

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 identified eight non-exclusive factors that indicate that the multiple facilities are operated as part of a single project. Some of the factors did not apply to certain projects. For example, a “merchant” project would not have a common power purchase agreement, and an equity-financed project would not have a common construction loan. The 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 Notice suggests that the IRS no longer considers the previously identified factors as 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. The omission of any specifically identified factors, however, could suggest that the emphasis is on how an individual project *operates*, as opposed to whether all eight identified factors are satisfied.

Disaggregation. The Notice also provides additional guidance with respect to the single project determination that was not addressed in the Prior Guidance.

First, the Notice clarifies that although multiple facilities may be treated as a *single project* for purposes of the Physical Work Test or the Five Percent Safe Harbor Test, the fact that some facilities may not satisfy the continuity requirement (and thus will not be eligible for the PTC) will not disqualify the other facilities that have satisfied that requirement from being eligible for the PTC. This is helpful guidance that resolves, in favor of the taxpayer, the considerable uncertainty as to whether the *single project* concept may be used, not only to qualify otherwise disqualified individual facilities within a single project, but to disqualify otherwise qualified individual facilities within a project as well.

Second, the 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. While this point was not entirely clear under the Prior Guidance, it is consistent with the Prior Guidance's focus on factors that have bearing on how a project will be operated once it is placed in service.

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, as 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 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 in such a situation (see Rev. Rul. 94-31). The Notice clarifies that, in the case of a single project comprised of multiple facilities, the 80/20 rule is applied to each individual facility comprising the single project, not to the project as a whole.

Footnotes

1."Phases" is an industry term, rather than nomenclature used in the notices.

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