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Orrick: IRS Issues Further Guidance on "Start of Construction" Requirement for Renewable Energy Tax Credits, Including Continuity Requirement.

On May 5, 2016, the IRS released Notice 2016-31, which provides additional guidance on the “start of construction” requirements for the production tax credit (PTC) and investment tax credit (ITC) in lieu of the PTC. Notice 2016-31 does not provide guidance with respect to the ITC for solar facilities. On May 18, 2016, the IRS revised Notice 2016-31. As discussed below, Notice 2016-31 provides additional guidance on satisfying the continuity requirement for beginning construction, satisfying the physical work test, and applying the five percent safe harbor to retrofitted facilities.

Under the Internal Revenue Code, eligible solar facilities currently can benefit from an ITC of 30% of the cost basis. Wind facilities can currently benefit from PTCs related to the quantity of renewable energy produced and sold during a taxable year (and, alternatively, can benefit from an ITC in lieu of PTCs). The ITC for solar and PTCs for wind were recently extended in legislation passed in December 2015.

Prior to the extension, the ITC was scheduled to be reduced to 10% for solar facilities placed in service after December 31, 2016. Prior to the extension, PTCs were available only for wind facilities for which construction began prior to January 1, 2015.

With the extension, solar facilities are eligible for a 30% ITC if construction begins before January 1, 2020. The 30% ITC for solar is phased down to 26% for facilities for which construction begins in 2020, to 22% for facilities for which construction begins in 2021, and to 10% for facilities for which construction begins after December 31, 2021. Additionally, to be eligible for the 30%, 26%, or 22% ITC, the solar facility must be placed in service before January 1, 2024 (if not, the ITC is reduced to 10%). Notice 2016-31 does not provide guidance with respect to the start of construction requirements for ITC with respect to solar facilities. The IRS anticipates issuing separate guidance addressing the extension of ITC for solar facilities.

For wind facilities, the extension provides for a phase down of PTCs over five years. Wind facilities for which construction begins before January 1, 2017 are eligible for the PTC at 100% of the current level. Wind facilities for which construction begins in 2017, 2018, and 2019 are eligible for reduced PTCs. The PTC reduction is 20% for 2017, 40% for 2018, and 60% for 2019. Wind facilities for which construction begins after December 31, 2019 would not be eligible for PTCs.

The IRS had previously provided guidance on when construction begins (Notices 2013-29, 2013-60, 2014- 46, and 2015-15). Notice 2013-29 provides two methods by which to satisfy the start of construction requirement. One method is to perform physical work of a significant nature. The other method is to pay or incur five percent or more of the total cost of a facility (the five percent safe harbor). In addition, work on the facility must be “continuous” in order for either method to be met (by meeting a “continuous program of construction” test or a “continuous efforts” test, as applicable). The continuity requirement is generally a facts and circumstances test. In Notice 2015-25, which was issued before the extension, the IRS provided that the continuity requirement would

be deemed met if a facility is placed in service before January 1, 2017 (two years after the former begun construction deadline).

Notice 2016-31 provides that the continuity requirement will be deemed met if a facility is placed in service before the later of (i) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began or (ii) December 31, 2016. For example, if 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. As a result of the four-year rule provided for in Notice 2016-31, it will be necessary to determine the year in which construction began when evaluating whether a facility qualifies for the continuity safe harbor. Under the prior guidance, this was not necessary because the continuity safe harbor was satisfied by placing a facility in service by a specific deadline.

Notice 2016-31 provides that the physical work test and the five percent safe harbor may not be relied upon in alternating years to satisfy the beginning of construction requirement or the continuity requirement. This prevents taxpayers from extending the four-year rule by, for example, relying on the physical work test in one year and then relying on the five percent safe harbor in a subsequent year.

If the continuity safe harbor is not met, the continuity requirement is evaluated under a facts and circumstances analysis. In prior guidance, the IRS had provided examples of excusable disruptions that would not cause the continuity requirement not to be met. Notice 2016-31 adds interconnection-related delays and delays in the manufacture of custom components to the list of excusable disruptions.

Notice 2016-31 provides additional examples to illustrate what qualifies as physical work of a significant nature for different types of renewable energy facilities, as follows:

- Wind facilities. On-site physical work of a significant nature may include the excavation for the foundation, the setting of anchor bolts into the ground, or the pouring of the concrete pads of the foundation.
- Hydropower facilities. On-site physical work of a significant nature may include the excavation for or construction of a penstock, power house, or retaining wall structure.
- Biomass and trash facilities. On-site physical work of a significant nature may include the performance of site improvements (as opposed to site clearing), such as filling or compacting soil, or installing stack piling.
- Geothermal facilities. On-site physical work of a significant nature may include physical activities that are undertaken at a project site after a valid discovery.

Finally, consistent with prior IRS guidance, Notice 2016-31 states that a facility may 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 twenty percent of the facility's total value (the cost of the new property plus the value of the used property). Notice 2016-31 provides that, for purposes of the five percent safe harbor, only expenditures incurred that relate to new construction are taken into account.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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