SUTHERLAND

LEGAL ALERT

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Have You "Begun Construction"? IRS Issues Guidance for Renewable Energy Tax Credits

On April 15, 2013, the Internal Revenue Service (IRS) issued much-anticipated guidance that will help developers of wind, solar, biomass and certain other renewable energy facilities qualify for federal renewable energy tax credits. The guidance explains how to satisfy the new "begun construction" requirement for the renewable energy section 45 production tax credit (PTC) and the election to claim the section 48 investment tax credit (ITC) in lieu of the section 45 PTC. That guidance, provided in Notice 2013-29 (the Notice),[1] was needed due to changes to the PTC and ITC (in lieu of PTC) made by the "Fiscal Cliff" legislation, which replaced a "placed in service date" requirement with a "begun construction" date requirement for these credits.

As expected, the guidance in the Notice closely resembles the rules adopted by the Treasury Department for the American Recovery and Reinvestment Act of 2009 section 1603 Treasury grant program. In both instances, the rules provide two methods for establishing the beginning of construction:

- Starting physical work of a significant nature, and
- Paying or incurring 5% or more of the total project cost.

Notwithstanding the many similarities between the begun construction rules in the Treasury grant program and the Notice, as noted below, taxpayers must be attuned to the significant differences that exist.

Sutherland Observation: While the Notice is fairly comprehensive, a number of questions regarding the implementation of the begun construction rules remain. We expect to address many of those questions with the IRS in the near-term.

Background: Fiscal Cliff Legislation Replaced Placed in Service Date Requirement with Begun Construction Date Requirement

The American Taxpayer Relief Act of 2012 (ATRA) (H.R. 8), also known as the Fiscal Cliff legislation, included a change in the deadlines for PTC-eligible facilities that require a taxpayer to have begun construction by the end of 2013 in order to qualify for a section 45 PTC or a section 48 ITC. Prior to ATRA, all PTC-eligible facilities, other than wind facilities, were required to be placed in service (*i.e.*, completed) before the end of 2013, and wind facilities were required to be placed in service by the end of 2012.

Following the passage of ATRA, the available renewable energy incentives under section 45 and under section 48 as an ITC in lieu of a PTC, include the following:[2]

[1] For a copy of the Notice, click here.

[2] Note that ATRA did not make any changes to the deadlines or placed in service requirements for renewable energy facilities for which only a section 48 ITC is available. Those facilities include solar, combined heat and power, qualified microturbine, qualified fuel cell and small wind projects.

	Deadline		Credit Amount	
	Pre-ATRA Project Must Have Been Placed In Service By:	**Post-ATRA** Construction of Project Must Begin By:	PTC Amount (per Kwh)	ITC Amount (% of eligible basis)
Wind	12/31/2012	12/31/2013	2.3 ¢	30%
Open-Loop Biomass	12/31/2013	12/31/2013	1.1 ¢	30%
Closed-Loop Biomass	12/31/2013	12/31/2013	2.3 ¢	30%
Geothermal	12/31/2013	12/31/2013	1.1 ¢	30%
Landfill Gas	12/31/2013	12/31/2013	1.1 ¢	30%
Trash	12/31/2013	12/31/2013	1.1 ¢	30%
Hydropower	12/31/2013	12/31/2013	1.1 ¢	30%
Marine & Hydrokinetic	12/31/2013	12/31/2013	1.1 ¢	30%

ATRA did not provide guidance regarding when a PTC-eligible facility would be treated as having begun construction, instead leaving that guidance to the IRS.

Sutherland Observation: Changing the deadline to a begun construction requirement was highly favorable for the renewable energy industry and a change that had been sought for some time. First, this change obviates concerns regarding potential and unexpected construction delays that would result in a failure to meet the placed in service deadline for the PTC or the ITC. Second, the change allows projects with longer construction schedules to be built even if construction does not begin until later in 2013.

The Treasury grant program provided a cash payment in lieu of a tax credit and was available for renewable energy facilities if the applicant had begun construction prior to the end of 2011 (and satisfied certain other requirements). In a series of FAQs and other guidance, Treasury developed, with the assistance of the IRS, guidance regarding when a grant applicant would be treated for purposes of that program as having begun construction. Since enactment of ATRA, many practitioners and renewable energy industry participants had urged the IRS to issue guidance implementing the ATRA begun construction requirement similar to the guidance provided for the Treasury grant program.

Notice Provides Two Methods for Determining When Construction Has Begun

Method #1: Starting Physical Work of a Significant Nature

Construction will be treated as having begun when "physical work of a significant nature" begins. For this purpose, physical work includes on-site and off-site work performed (1) by the taxpayer or (2) for the taxpayer by another person under a "binding written contract" that is entered into prior to such work being performed.

A contract will be treated as a "binding written contract" if it is enforceable under local law against the taxpayer or a predecessor and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). If a taxpayer enters into a master contract for a number of components to be manufactured by another person for use by the taxpayer, and then through a new written binding contract, the taxpayer assigns its rights to certain components to an affiliated special purpose entity that

will own the facility, work performed under the master written contract may be taken into account in determining whether physical work of a significant nature has been undertaken.

Sutherland Observation: The Treasury grant guidance provided that a contract that limits damages to at least 5% of the total contract price would not be treated as limiting damages to a specified amount. The Notice does not expressly adopt this same position.

Physical work of a significant nature does not include work with respect to preliminary activities, even if the cost of those activities is includable in the depreciable basis of the project,[3] or work to produce property that is "either existing inventory or is normally held in inventory by a vendor."

Physical work of a significant nature does include work on tangible personal property and other tangible property used as an integral part of the activity performed by the facility. Such property includes property integral to the production of electricity, but not property used for electrical transmission.[4] For purposes of these rules, a facility includes "all components that are functionally interdependent – *i.e.*, if the placing in service of each of the components is dependent upon the placing in service of each of the other components in order to generate electricity." For purposes of determining whether physical work of a significant nature has begun for a project that includes multiple facilities (*e.g.*, a wind farm), "multiple facilities that are treated as part of a single project" will be treated, in effect, as a single facility.[5] For example, work on 10 turbines of a 50 turbine wind farm may qualify the entire wind farm as having begun construction.

Method #2: Paying or Incurring 5% or More of the Total Project Cost

Construction also will be treated as having begun if a taxpayer pays or incurs (based on its method of accounting) 5% or more of the total cost of the facility before the end of 2013 (also referred to as the "5% safe harbor"). For this purpose, the total cost of the facility includes all costs of property integral to the facility that are properly includable in the depreciable basis of the facility.

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[3] The Notice provides the following examples of activities that will be treated as "preliminary activities": "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 (as distinguished from excavation for footing and foundations)." In addition, the Notice provides that removal of existing turbines and towers is a preliminary activity.

[4] The Notice specifically addresses the following types of equipment with regard to whether such equipment is "integral":

- Power conditioning equipment, such as a transformer that steps up the voltage of electricity produced to the voltage needed for transmission, is an integral part of the activity performed by the facility.
- Roads are integral if used for moving materials to be processed (*e.g.*, biomass) or used for equipment to operate and maintain the facility. However, roads used primarily for access to the site or for employee or visitor vehicles are not integral.
- Fencing is not integral.
- Buildings are integral if they are (1) a structure that is essentially an item of machinery or equipment, or (2) a structure that houses property that is integral to the activity of the facility if the use of the structure is so closely related to the use of the housed property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Otherwise, buildings are not considered integral.

[5] Factors indicating that multiple facilities are operated as part of a single project include: (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.

Costs incurred for the taxpayer by another person to manufacture, construct or produce property under a "binding written contract" that are incurred before the property is provided to the taxpayer are deemed incurred by the taxpayer when they are incurred by the other person.

The Notice also provides guidance regarding cost overruns that ultimately result in actual costs that cause the taxpayer to not reach the requisite 5% threshold (notwithstanding that the taxpayer paid or incurred 5% or more of estimated project costs by the end of 2013). In the case of a facility that is a single project comprised of multiple facilities, the taxpayer may exclude certain facilities in order to satisfy the requisite 5% threshold. Any excluded facility, however, is not eligible for a PTC or ITC. In the case of a single facility project, if cost overruns result in the requisite 5% threshold not being satisfied, the taxpayer will be treated as not having begun construction (unless the taxpayer satisfies the physical work of a significant nature method).

Notice Includes Post-2013 Requirements: Continuous Construction/Continuous Efforts

If a taxpayer avails itself of the physical work of a significant nature method, the Notice warns that the IRS will closely scrutinize a facility, and may determine that construction did not begin before the end of 2013, if a taxpayer does not maintain a "continuous program of construction."

Similarly, if a taxpayer avails itself of the 5% safe harbor method, it must make "continuous efforts to advance toward completion of the facility" thereafter. In determining whether that requirement is satisfied, the IRS will consider as favorable factors: (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 physical work of a significant nature.

The Notice provides that whether a taxpayer maintains a continuous program of construction or makes continuous efforts to advance toward completion of the facility "will be determined by the relevant facts and circumstances."

Sutherland Observation: The continuous program of construction requirement for the physical work of a significant nature method provided in the Notice is similar to the requirement for that method in the Treasury grant program. However, the Treasury grant program did not include a continuous efforts requirement for the 5% safe harbor similar to that provided in the Notice. Because of the subjective nature of the continuous program of construction requirement, many Treasury grant applicants utilized the 5% safe harbor method.

Projects under the Treasury grant program were required to be completed by the then-applicable statutory placed in service date requirement under sections 45 or 48 (*i.e.*, end of 2012, 2013 or 2016) for the renewable energy technology employed by the facility. Post-ATRA, no similar placed in service date requirement exists for PTC-eligible facilities, thus necessitating some method of ensuring that construction of qualifying facilities is not unduly delayed. The new "continuous efforts" requirement was presumably therefore included in the Notice. As a result, both methods of satisfying the begun construction requirement now include a subjective post-2013 requirement that may cause some discomfort for taxpayers.

Certain disruptions in a taxpayer's construction of a facility that are "beyond the taxpayer's control" will not be considered as indicating that a taxpayer failed its post-2013 requirement for either method. Those disruptions include, but are not limited to: (a) severe weather conditions; (b) natural disasters; (c)

licensing and permitting delays; (d) delays at the written request of a state or federal agency regarding matters of safety, security or similar concerns; (e) labor stoppages; (f) inability to obtain specialized equipment of limited availability; (g) the presence of endangered species; (h) financing delays of less than six months; and (i) supply shortages.

Sutherland Observation: Under the Treasury grant program, Treasury provided the grant applicant a preliminary determination that the begun construction guidance was satisfied after the grant applicant filed a preliminary grant application. Consequently, many Treasury grant program applicants were able to receive some comfort that Treasury concurred that construction of their projects had begun well before project completion. Because the section 45 PTC and section 48 ITC are claimed on a taxpayer's federal income tax return, there is limited opportunity to obtain similar comfort with regard to the section 45 PTC and section 48 ITC.

In light of the significant economic value of the tax credits, and the fact that many renewable energy projects are not economic absent the tax credits, taxpayers must carefully review the Notice and be fully cognizant of the begun construction rules through a proper evaluation of the Notice, the relevant ATRA provisions, sections 45 and 48 and the Treasury regulations thereunder, and the Treasury grant program guidance. Taxpayers may find it necessary in certain instances to seek further clarification from the IRS.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work

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