



## On the Subject

### IRS Issues Guidance on Beginning of Construction Rules for Renewable Projects

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On May 5, 2016, the Internal Revenue Service (IRS) issued Notice 2016-31, providing guidance on meeting the beginning of construction requirements for wind and other qualified facilities (including biomass, geothermal, landfill gas, trash, hydropower, and marine and hydrokinetic facilities). The Notice extends the “Safe Harbor” placed in service date by which a facility can meet the beginning of construction tests to correspond with the extension and modification of the Section 45 production tax credit (PTC) passed by Congress at the end of 2015. Specifically, the Notice states that if a facility is placed in service no more than four calendar years after the calendar year in which construction of the facility began, the facility will be considered to satisfy the Continuity Requirement.

The Notice also provides examples of the application of the Physical Work Test to different types of renewable energy facilities, as well as examples of preliminary activities not qualifying as physical work. The Notice revises and adds to the non-exclusive list of excusable disruptions with respect to the Continuity Requirement. Finally, the Notice clarifies the application of the Safe Harbor to retrofitted facilities. According to the Notice, the IRS will issue separate guidance addressing the extension of the investment tax credit (ITC) for solar facilities under Section 48.

#### BACKGROUND

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 amended the PTC and the ITC. Specifically, the Act included multi-year extensions of the PTC and the ITC for wind and solar projects, along with a gradual phase-out of the credit.

In the case of wind, the Act extended the PTC through 2019 (including the corresponding election to take the ITC in lieu of the PTC for wind projects), such that wind projects that have begun construction prior to the end of 2019 will be eligible for the PTC or ITC. Previously, the PTC for wind only applied to projects beginning construction before the end of 2014.

The Act also reduces the PTC and ITC for wind by 20 percent for projects commenced in 2017, by 40 percent for projects commenced in 2018, and by 60 percent for projects commenced in 2019. For energy facilities other than wind, such as biomass and geothermal projects, the Act extends the PTC through the end of 2016 and includes a corresponding extension of the election to take the ITC in lieu of the PTC. For more information on the Act’s extension of renewable energy tax incentives, including the extension of the ITC for solar projects, click [here](#).

The Notice updates the guidance provided in prior notices (Notice 2013-29, Notice 2013-60, Notice 2014-46 and Notice 2015-25, together referred to herein as the Prior Guidance) consistent with the statutory extension under the Act. The Notice explains that the IRS will not issue private letter rulings to taxpayers regarding the application of the Notice or the application of the beginning of construction requirement pursuant to Sections 45(d) and 48(a)(5).

### *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 5 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 excavation for the foundation, the setting of anchor bolts into the ground or the pouring of the foundation’s concrete pad. Both onsite and offsite work may be taken into account. The IRS 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 until the relevant project is placed in service.

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 the accrual rules of Treasury Regulation Section 1.461-1(a)(1) and (2)) 5 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. (The Continuous Construction Test and the Continuous Efforts Test are referred to herein collectively as the Continuity Requirement.)

For more information on these tests and their requirements, see [McDermott’s article on Notice 2013-29](#).

### *Notice 2013-60*

In September 2013, the IRS issued Notice 2013-60, clarifying questions left outstanding by Notice 2013-29. See [McDermott’s summary in its article on Notice 2013-60](#). Specifically, Notice 2013-60 provided that a facility was to be considered to satisfy the Continuity Requirement if it was placed in service before January 1, 2016. Notice 2013-60 also 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*

Notice 2014-46 clarified that the Physical Work Test focuses on the nature of the work performed rather than the amount or cost of such work. Notice 2014-46 also provides guidance

regarding transfers of a facility by the taxpayer that begins construction of a facility prior to placing the facility in service. Notice 2014-46 modified the Safe Harbor rule set forth in earlier guidance by providing that, if a taxpayer incurred at least 3 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. See [McDermott’s summary in its article on Notice 2014-46](#).

### *Notice 2015-25*

Notice 2015-25 extended the relevant Safe Harbor placed in service dates under the earlier notices so that the beginning of construction guidance mirrored the statutory extension of the PTC and the ITC under the Tax Increase Prevention Act of 2014 (TIPA). Prior to the extension under TIPA, Sections 45(d) and 48(a)(5) required that construction of a qualified facility begin before January 1, 2014, for the facility to be eligible for the PTC or the ITC. Based on the language of those sections as in effect before TIPA, the Prior Guidance provided advice on determining whether construction had begun on a qualified facility prior to January 1, 2014. Because TIPA extended the date by which construction of a qualified facility must begin to January 1, 2015, Notice 2015-25 extended the Safe Harbor placed in service date to meet the Continuity Requirements to January 1, 2017. See [McDermott’s summary in its article on Notice 2015-25](#).

### *Notice 2016-31*

The Notice provides that a facility will be considered to satisfy the Continuity Requirement if the facility is placed in service during a calendar year that is no more than four calendar years after the calendar year during which construction on the facility began (the Continuity Safe Harbor). As an example, the Notice provides that if construction on a wind facility began 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. If the facility is not placed in service within the requisite time period, relevant facts and circumstances will determine whether the facility meets the Continuity Safe Harbor (*i.e.*, whether the Continuous Construction Test or Continuous Efforts Test may be satisfied, as described in Sections 4.06 and 5.02 of Notice 2013-29).

The Notice also states that a taxpayer cannot alternate between the Physical Work Test and the Safe Harbor to satisfy

the beginning of construction requirement or the Continuity Requirement. For example, if a taxpayer relied on the Physical Work Test to satisfy the beginning of construction rules in 2015, and in 2016 incurs costs totaling 5 percent or more of the total cost of the facility, the taxpayer cannot then use the Safe Harbor to satisfy the beginning of construction requirement or the Continuity Requirement. Under the facts recited in the example, the IRS states that the Continuity Requirement is applied beginning in 2015, the earlier taxable year. This rule prevents a taxpayer from being able to restart the four-year window for placing the facility in service by using the other beginning of construction method to qualify the facility as having begun construction in the later year.

There has been some confusion surrounding this language in the Notice, so the IRS may offer clarification. That potential clarification may provide that the beginning of construction year is the very first year in which construction began, regardless of the method used or subsequent beginning of construction activities. For some projects that began construction in earlier years, this safe harbor ultimately may be difficult to meet. For example, if a facility began construction by physical work in 2014 and the project is not intended to be placed in service until 2019, the facility will not be able to meet the four-year safe harbor. On the other hand, pinning the beginning of construction year to the first year in which qualifying activities occurred may be helpful for determining the credit amount under the phase-out rules.

### *New Excusable Disruptions*

In the Prior Guidance, the IRS provided a non-exclusive list of nine construction disruptions beyond a taxpayer's control that will not be considered as indicating that a taxpayer has failed the Continuous Construction Test or the Continuous Efforts Test. This list can be found in [McDermott's summary of Notice 2013-29](#).

The Notice revises this list and adds two excusable disruptions. The Prior Guidance provided that a financing delay of "less than six months" was an excusable disruption. The Notice revises this to eliminate the time limit such that any financing delay may constitute an excusable disruption. The Notice also clarifies that licensing and permitting delays encompass delays in obtaining licenses and permits from federal, state, local or Indian tribal governments, and include, but are not limited to, delays in obtaining licenses and permits

from the Federal Energy Regulatory Commission, the US Environmental Protection Agency, the Bureau of Land Management and the Federal Aviation Agency. The Notice further adds as excusable disruptions beyond the taxpayer's control the following two items:

- Interconnection-related delays
- Delays in the manufacture of custom components

The Notice describes interconnection delays as relating to the completion of construction of a new transmission line or necessary transmission upgrades to resolve grid congestion issues that may be associated with a project's planned interconnection. These are helpful additional exceptions, although there remains uncertainty as to how long any of these delays may continue before the Continuity Requirement is no longer met. In addition, it is unclear whether a very short delay for a reason that is not set forth in this list would cause a project to fail the Continuity Requirement.

### *Examples of Work for the Physical Work Test*

As noted, 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 excavation for the foundation, the setting of anchor bolts into the ground or the pouring of the foundation's concrete pad. The example with respect to a wind facility remains in the Notice, but the IRS provides additional examples of work that meets the Physical Work Test for different types of renewable energy projects. The following non-exclusive list illustrates the kind of work that will meet the Physical Work Test for the various facilities:

- Hydropower Facilities – The excavation for or construction of a penstock, power house or retaining wall
- Biomass and Trash Facilities – The performance of site improvements (as opposed to site clearing), such as filing or compacting soil, or installing stack piling
- Geothermal Facilities – Physical activities that are undertaken at a project site after a valid discovery

### *Preliminary Activities*

The Prior Guidance described a list of activities that constituted preliminary activities that would not constitute "physical work of a significant nature" for purposes of the Physical Work Test. The Notice retains the previously

identified activities and clarifies that not only is the removal of existing wind turbines and towers considered a preliminary activity, but so is the removal of existing solar panels or any components that will no longer be part of the facility. The Notice also adds as a preliminary activity geologic mapping and modeling.

#### *Single Project Rule and Disaggregation*

The Prior Guidance provided that, solely for determining whether construction of a facility has begun for purposes of the PTC and the ITC, multiple facilities that are operated as part of a single project will be treated as a single facility. The Notice clarifies that the single project rule may be applied to facilities that rely upon either the Physical Work Test or the Safe Harbor to satisfy the Continuity Requirement. The Notice states that the determination of whether multiple facilities are operated and treated as a single project for beginning of construction purposes must be determined in the calendar year during which the last of the multiple facilities is placed in service.

For purposes of determining whether a facility satisfies the Continuity Safe Harbor, however, multiple facilities that are operated as part of a single project and facility for purposes of determining whether construction has begun may be disaggregated and treated as multiple separate facilities. The Notice provides that disaggregated facilities that are placed in service prior to the Continuity Safe Harbor deadline will be eligible for the safe harbor, and the remaining disaggregated facilities may satisfy the Continuity Requirement under a facts and circumstances determination. Facilities that rely upon either the Physical Work Test or the Safe Harbor to satisfy the Continuity Requirement may apply this disaggregation rule.

The Notice provides the following example to illustrate these rules. A developer is developing a wind farm that will consist of 50 turbines. On June 1, 2018, the developer excavates the site for the foundations of 10 of the 50 turbines and pours concrete for the supporting pads. The example concludes that the developer has satisfied the Physical Work Test. However, if before January 1, 2023, the developer has only placed into service 40 of the 50 turbines, the developer may disaggregate the 50 turbines such that 40 of the turbines will be treated as satisfying the Continuity Safe Harbor. With respect to the remaining 10 turbines, the developer will have to demonstrate

that it satisfies the Continuous Construction Test based on the facts and circumstances.

#### *Retrofitted Facilities and the Safe Harbor*

The Notice provides that, as indicated in prior IRS authority, a retrofitted facility may qualify as originally placed in service for purposes of the tax credits if the fair market value of used property does not constitute more than 20 percent of the facility's total value. Thus, the cost of the facility's new property must be at least 80 percent of the facility's total value (the 80/20 Rule). With respect to a single project composed of multiple facilities, the Notice states that the 80/20 Rule applies to each individual facility comprising the single project. Moreover, the Safe Harbor is applied only with respect to the cost of the new property used to retrofit an existing facility.

The Notice provides the following example to illustrate the application of these rules. A taxpayer owns a wind farm composed of 13 turbines, pad and towers that no longer qualify for either the PTC or the ITC. Each facility has a fair market value of \$1 million. The taxpayer replaces components worth \$900,000 on 11 of the 13 facilities at a cost of \$1.4 million for each facility. The fair market value of the remaining original components at each upgraded facility is \$300,000. Thus, the total fair market value of each upgraded facility is \$1.7 million. The total expenditures to retrofit the 11 facilities are \$15.4 million. The taxpayer applies the single project rule. Because the fair market value of the remaining original components of each upgraded facility (\$300,000) is not more than 20 percent of each facility's total value of \$1.7 million, each upgraded facility will be considered newly placed in service for purposes of the PTC and the ITC. Accordingly, if the taxpayer pays or incurs at least \$770,000 (or 5 percent of \$1.4 million) of qualified expenditures in 2016, the single project will be considered to have begun construction in 2016. Provided the taxpayer also meets the Continuous Efforts Test, each upgraded facility will be treated as a qualified facility for purposes of the PTC. However, no additional PTC or ITC will be allowed with respect to the two facilities that were not upgraded.

#### **CONCLUSION**

The Notice provides necessary clarity for taxpayers regarding the beginning of construction rules in light of the statutory extension and modification of the PTC and ITC pursuant to the Act. In addition, the revision of and addition

to the list of excusable disruptions that will not be taken into account for determining the Continuity Requirement will provide more certainty for taxpayers. Until the IRS issues additional guidance related to solar facilities, this Notice may provide insight regarding the extension and phase-out of the ITC under Section 48.

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