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Client Alert

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IRS Issues Guidance on "Begun Construction" Requirement for Renewable Energy Credits

On April 15, 2013, the IRS released much-awaited guidance on the "begun construction" requirement for renewable energy facilities seeking to qualify for production tax credits and investment tax credits under Sections 45 and 48 of the US Internal Revenue Code (IRC). Notice 2013-29, subsequently updated on April 25, 2013, generally follows a similar approach to the "begun construction" requirement as the expired cash grant program under Section 1603 of the American Recovery and Reinvestment Act of 2009, with some modifications as discussed below. This consistency of approach will be welcomed by taxpayers familiar with the cash grant program as they ramp up to grandfather their projects before the end of this year. However, additional IRS guidance on some issues may be necessary or desirable for many taxpayers.

Section 45 and 48 Credits

IRC Section 45 allows a production tax credit (PTC) for each kilowatt hour of electricity produced by qualifying energy facilities and sold to unrelated persons during the 10-year period following the placed-in-service date of the facility. Qualifying energy facilities include wind, geothermal, closed-loop biomass, open-loop biomass, landfill gas, trash, qualified hydropower and marine and hydrokinetic facilities. Since 2009, taxpayers have had the option of electing to treat a facility that qualifies for PTCs as qualifying energy property under IRC Section 48, and claiming a one-time investment tax credit (ITC) equal to 30 percent of the cost of eligible property included in the facility in lieu of PTCs.

Before 2013, IRC Section 45 imposed a placed-in-service deadline in order to qualify for PTCs. The deadline was December 31, 2012 for wind facilities and December 31, 2013 for other qualifying energy facilities. Legislation enacted in January 2013 significantly modified this deadline by converting the placed-in-service deadline to a "begun construction" deadline and extending the deadline for wind facilities to December 31, 2013. As amended, an owner of a qualifying energy facility may claim PTCs, or ITCs in lieu of PTCs, if construction of the facility begins before January 1, 2014. This approach is similar to the cash grant statute, which authorizes cash grants for eligible projects that began construction before January 1, 2012 and are placed in service by a certain date. However, in contrast to the cash grant statute, there is no statutory outside placed-in-service deadline for qualifying energy facilities that meet the "begun construction" requirement of IRC Section 45.

Begun Construction

Similar to the cash grant program, Notice 2013-29 establishes two ways to satisfy the "begun construction" requirement of IRC Section 45: (1) a safe harbor based on costs incurred by the taxpayer or (2) by starting physical work of a significant nature.

Five Percent Safe Harbor

Under the safe harbor, construction of a facility will be considered as having begun before January 1, 2014, if the taxpayer (1) incurs five percent or more of the total cost of the facility before January 1, 2014 and (2) makes continuous efforts to advance towards completion of the facility thereafter.

In calculating the safe harbor percentage, the Notice generally follows the cash grant program rules. Only costs includible in the depreciable basis of a facility (excluding land and any other property not integral to the production of electricity) will be taken into account when such costs are treated as incurred under the tax accounting rules, as modified by the Notice. In this regard, as discussed below, the IRS has retained the special look-through rules from the cash grant program, which allow a taxpayer to count costs incurred by its contractors before such costs are technically incurred by the taxpayer. The Notice also makes clear that cost overruns can cause a facility to fail to satisfy the safe harbor. However, if a project comprises multiple facilities that can be separated (*e.g.*, a wind farm that consists of multiple turbines), a taxpayer may claim PTCs or ITCs with respect to individual facilities for which the safe harbor was met.

The "continuous efforts" prong is a new safe harbor requirement, likely necessitated by the lack of an outside placed-in-service deadline as compared to the cash grant program. Satisfaction of this prong will be determined based on the relevant facts and circumstances, with the following facts considered indicative of continuous efforts to advance towards completion of the facility: (1) paying or incurring additional costs to develop and construct the facility, (2) entering into construction and supply agreements for the facility, (3) obtaining necessary permits and (4) beginning actual physical work on the facility beyond preliminary planning and development activities. In other words, taxpayers will not be permitted to stockpile equipment before the end of the year for use in future projects that are not currently in development or at least in the pipeline.

Consistent with the cash grant program, certain disruptions of a taxpayer's development and construction efforts due to circumstances beyond the taxpayer's control generally will not count against the taxpayer. Examples of such disruptions provided in the Notice include (1) severe weather conditions and natural disasters, (2) licensing and permitting delays, (3) regulatory delays for matters of safety, security, or similar concerns, (4) labor stoppages, (5) equipment shortages, (6) the presence of endangered species and (7) financing delays of less than six months.

Physical Work Test

As an alternative to the safe harbor, a taxpayer can satisfy the "begun construction" requirement by beginning "physical work of a significant nature" with respect to the facility (or its component parts) before January 1, 2014 and thereafter maintaining a continuous program of construction. Both on-site and off-site work may be taken into account, whether performed by the taxpayer or by other persons pursuant to a binding written contract with the taxpayer, as described below.

The Notice does not address the amount of activity that will constitute "physical work of a significant nature," and thus it is unclear whether the IRS will set a higher bar for the physical work test than the relatively low bar previously set under the cash grant program. As under the cash grant program, neither preliminary development activities nor physical work on property that is not integral to the facility's production of electricity (*e.g.*, site access roads, fencing, O&M buildings and transmission equipment) count as beginning construction under the physical work test. Off-site manufacturing of facility components will be taken into account only if the component parts are not normally held in inventory by the manufacturer and are produced pursuant to a binding written contract with the taxpayer entered into before the work takes place.

Interestingly, the Notice provides that for purposes of determining when physical work of a significant nature begins under the physical work test—but unclear whether for purposes of the safe harbor—work performed under a master equipment contract on components to be manufactured, constructed, or produced for the taxpayer by another person and that are assigned by the taxpayer to an "affiliated special purpose vehicle" (the project company) that will own the facility, may be taken into account. The Notice does not define "affiliated," but where the project company is disregarded as separate from the taxpayer for tax purposes, that work should count under general tax principles because the taxpayer, rather than the project company, is deemed to own the facility for tax purposes. For related entities that are separately regarded for tax purposes, additional guidance on this point will be necessary.

The Notice also offers little detail on what constitutes "continuous construction," providing only that disruptions of a facility's construction outside the taxpayer's control generally will not count against the taxpayer. The Notice states that the IRS will closely scrutinize a facility if a taxpayer does not maintain a continuous program of construction, but does not provide an indicative list of factors similar to the "continuous efforts" prong of the safe harbor. Under the cash grant program, this requirement was generally understood to mean the project must be completed within a normal timeframe for the particular type of project.

Look-Through Rules

The Notice retains the special look-through rules from the cash grant program that treat a taxpayer as having incurred costs for, or beginning physical work on, property manufactured, constructed or produced for the taxpayer by another person under a binding written contract, as the costs are incurred or the work is performed by the other person. Under the Notice, a contract is considered binding only if it is enforceable under local law against the taxpayer or a predecessor and does not limit damages to a specified amount. As updated, the Notice follows the cash grant program rules, as well as other IRS precedents, and treats a contractual provision that limits damages to an amount equal to at least five percent of the total contract price as not limiting damages to a specified amount.

Multiple Facilities/Single Project

For purposes of determining the beginning of construction—but not the placed-in-service date—the Notice permits taxpayers to treat multiple facilities (along with ancillary property, such as a computer control system) as a single facility if they will be operated as a single project. This rule generally will benefit wind farms because each wind turbine, pad and tower is treated as a separate facility under the tax rules. Thus, a taxpayer can satisfy the "begun construction" requirement on a project-wide basis, rather than a turbine-by-turbine basis. This rule may be of less benefit to projects in which the component parts are functionally interdependent and cannot be operated independently of each other, such as a biomass or geothermal facility.

Whether multiple facilities are operated as part of a single project is a facts and circumstances analysis. The Notice sets forth the following non-exclusive list of factors indicative of a single project: (1) ownership by a single legal entity, (2) constructed on contiguous pieces of land, (3) common power purchase agreement or agreements, (4) common intertie, (5) common substation, (6) common environmental or

other regulatory permits, (7) single master construction contract and (8) financed pursuant to the same loan agreement.

Planning Considerations

On the whole, the Notice is significantly less detailed than the existing guidance under the cash grant program, and it remains unclear to what extent taxpayers can comfortably rely on the cash grant program rules for issues not addressed in the Notice. The cash grant program guidance is not binding on the IRS and there can be no assurance that the IRS will adopt the same views. For example, it would be helpful for the IRS to confirm whether costs incurred by a taxpayer under a master contract for property that is assigned to a project company count towards satisfying the safe harbor with respect to that facility, as well as to clarify the meaning of "affiliated." As discussed above, where the project company is disregarded as separate from the taxpayer for tax purposes, those costs should count because the taxpayer is deemed to own the facility for tax purposes.

Another area where additional guidance may be needed is the impact of transfers of full or partial ownership of a project company after the "begun construction" requirement has been satisfied but before the qualifying energy facility is placed in service. Does a change in ownership disqualify a project if the change results in the project being owned by a different taxpayer from the one that satisfied the "begun construction" requirement? As a practical matter, most facilities are held in special purpose project companies that, while separate legal entities, are usually disregarded as separate from their upstream owners. It is not uncommon to sell a direct or indirect interest in a project company at or prior to the placed-in-service date, resulting in the project being owned by a new partnership for tax purposes.

Finally, taxpayers will need to take the initiative to adequately document that they satisfied the "begun construction" requirement for each project. The Notice does not specify any documentation requirements, but taxpayers would be well-advised to prepare and maintain the same type of documentation required to establish "begun construction" under the cash grant program, including evidence of the costs paid or incurred before January 1, 2014, or a report from an independent engineer documenting the work commenced before January 1, 2014.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Julie Marion
+1.312.876.7658
Julie.marion@lw.com
Chicago

Rene de Vera
+1.312.876.7610
Rene.devera@lw.com
Chicago

Global Offices

Abu Dhabi
Barcelona
Beijing
Boston
Brussels
Chicago
Doha
Dubai
Frankfurt
Hamburg
Hong Kong
Houston
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Los Angeles
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Rome
San Diego
San Francisco
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, D.C.

* In association with the Law Office of Salman M. Al-Sudairi

Abu Dhabi
Villiers Terblanche
+971.2. 495.1700

Barcelona
Jordi Domínguez
+34.93.545.5000

Beijing
Allen C. Wang
+86.10.5965.7000

Boston
David O. Kahn
+1.617.948.6000

Brussels
Jean Paul Poitras
+32.2.788.6000

Chicago
Diana S. Doyle
+1.312.876.7700

Doha
Villiers Terblanche
+974.4406.7700

Dubai
Villiers Terblanche
+971.4.704.6300

Frankfurt
Anders Kraft
+49.69.6062.6000

Hamburg
Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong
Michael S. L. Liu
+852.2912.2500

Houston
C. Timothy Fenn
+1.713.546.5400

London
Sean Finn
Daniel Friel
+44.20.7710.1000

Los Angeles
Orange County
Samuel R. Weiner
Pardis Zomorodi
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Christopher Allen
+7.495.785.1234

Munich
Thomas Fox
Stefan Süss
+49.89.2080.3.8000

New York
David S. Raab
Lisa G. Watts
+1.212.906.1200

Paris
Olivia Rauch-Ravisé
Xavier Renard
+33.1.4062.2000

Riyadh*
Salman Al-Sudairi
+966.1.207.2500

Rome
Fabio Coppola
+39.06.98.95.6700

San Diego
Laurence J. Stein
+1.619.236.1234

San Francisco
Kirt Switzer
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Kirt Switzer
+1.650.328.4600

Singapore
Stephen McWilliams
+65.6536.1161

Tokyo
Joseph Bevash
+81.3.6212.7800

Washington, D.C.
Nicholas J. DeNovio
Cheryl M. Coe
+1.202.637.2200