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Tax Group Client Alert:

IRS Notice 2016-31: Beginning Construction Under the PATH Act

On May 5, 2016, the Internal Revenue Service (the "IRS") released Notice 2016-31 (the "Notice"), which clarifies the circumstances under which a taxpayer will be treated as having begun construction for purposes of qualifying for the production tax credit (the "PTC") under section 45 of the Internal Revenue Code (the "Code"). (A copy of the Notice can be found here.)

BACKGROUND

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"),[1] which extended the PTC for certain eligible facilities the construction of which begins before January 1, 2017, and in the specific case of wind facilities, the construction of which begins before January 1, 2020. In the case of wind facilities the construction of which begins after December 31, 2016 and before January 1, 2020, the PTC will be phased out (*i.e.*, the PTC will be reduced by 20% if construction begins in 2017, 40% if construction begins in 2018 and 60% if construction begins in 2019). The PATH Act also extended the investment tax credit ("ITC") for solar energy facilities, the construction of which begins before January 1, 2022.

On April 15, 2013, the IRS published Notice 2013-29,[2] providing guidance on what it means to "begin construction" under the American Taxpayer Relief Act of 2012 (the "ATRA"), the original legislation that introduced the "begun construction" requirement.[3] Under the ATRA, a taxpayer was required to begin construction of a qualified facility before January 1, 2014. (A copy of Notice 2013-29 can be found here.) Notice 2013-29 provided two alternative ways to demonstrate that construction had begun: (1) by beginning physical work of a significant nature before January 1, 2014 (the "physical work test") and (2) by paying or incurring at least 5% of the total cost of the eligible property before January 1, 2014 (the "5% safe harbor").[4] Among other requirements, the physical work test requires that the taxpayer maintain a continuous program of construction and the 5% safe harbor requires that the taxpayer maintain continuous efforts to advance towards completion of the project, in each case after construction has begun (or, in the case of the 5% safe harbor, after 5% of the total costs have been paid or incurred).

[1] Pub. L. No. 114-113, Div. Q, 129 Stat. 2242 (2015).

[2] I.R.S. Notice 2013-29 (Apr. 15, 2013).

[3] Pub. L. No. 112-240, 126 Stat. 2313 (2013).

[4] Notice 2013-29, § 3.

On September 20, 2013, the IRS published Notice 2013-60 clarifying certain aspects of the guidance provided in Notice 2013-29.[5] (A copy of Notice 2013-60 can be found here.) Specifically, Notice 2013-60: (1) provided a "safe harbor" in applying the "continuous efforts" and "continuous construction" requirements (collectively, the "continuity safe harbor"), (2) addressed the applicability of costs incurred under a master supply contract to the 5% safe harbor, and (3) clarified that a facility remained eligible even if transferred after construction had begun. On August 8, 2014, the IRS released Notice 2014-46 ("Notice 2014-46"), clarifying and modifying Notices 2013-29 and 2013-60.[6] (A copy of Notice 2014-46 can be found here.) (Our prior Client Alerts on the ATRA, Notice 2013-29, Notice 2013-60 and Notice 2014-46 can be found here, here, here and here.)

On December 19, 2014, the Tax Increase Prevention Act of 2014 extended by one year, to January 1, 2015, the date by which construction of a qualified facility must begin.[7] On March 30, 2015, the IRS released Notice 2015-25 ("Notice 2015-25"), extending by one year the continuity safe harbor described in Notice 2013-60. (A copy of Notice 2015-25 can be found here.) Under Notice 2015-25, if a taxpayer began construction on a facility before January 1, 2015, and places the facility in service before January 1, 2017, the facility will be considered to satisfy the continuity safe harbor regardless of the amount of physical work performed or the amount of costs paid or incurred with respect to the facility after December 31, 2014 and before January 1, 2017.

To address the latest extension of the begun construction requirement provided for in the PATH Act, the IRS released the Notice. The Notice (1) further extends and modifies the continuity safe harbor, (2) provides additional guidance regarding the application of the continuity safe harbor and the physical work test and (3) clarifies the application of the 5% safe harbor to retrofitted renewable energy facilities. The Notice also provides that unless otherwise specified, the guidance provided in Notice 2013-29, Notice 2013-60, Notice 2014-46 and Notice 2015-25 continues to apply. The Notice does not provide guidance with respect to the extension of the ITC for solar energy facilities. Separate guidance addressing the ITC for solar energy facilities is expected to follow.

CONTINUITY SAFE HARBOR

The Notice extends the continuity safe harbor provided in Section 3.02 of Notice 2013-60 by providing that the continuity safe harbor will be satisfied as long as a taxpayer places a facility in service during a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began.[8] To illustrate, the Notice provides that if construction begins on January 15, 2016 and the facility is placed in service by December 31, 2020, the continuity safe harbor will have been satisfied.

The Notice specifies that a taxpayer may not rely upon the physical work test and 5% safe harbor in alternating calendar years. The Notice provides the example that if a taxpayer performs physical work of a significant nature on a facility in 2015, and then pays or incurs five percent or more of the total cost of the facility in 2016, the

[5] Notice 2013-60 (Sept. 20, 2013).

[6] I.R.S. Notice 2014-46 (Aug. 8, 2014).

[7] Pub. L. No. 113-295, 128 Stat. 4021 (2014).

[8] Notice 2016-31, § 3.

continuity safe harbor will be applied beginning in 2015, not in 2016. The facility in this example will have to be placed in service no later than December 31, 2019 in order to satisfy the continuity safe harbor.

In addition, the Notice revises and expands the non-exclusive list of construction disruptions specified in Notice 2013-29 that will not be indicative of a taxpayer's failure to maintain a continuous program of construction or make continuous efforts towards the completion of a facility.[9] Specifically, the Notice includes as additional excusable disruptions (1) interconnection-related delays (*e.g.*, those relating to the completion of construction on a new transmission line or necessary transmission upgrades to resolve grid congestion issues that may be associated with a project's planned interconnection) and (2) delays in the manufacture of custom components.[10] In addition, with respect to delays in obtaining permits or licenses, the Notice includes as examples FERC, EPA, BLM and FAA licenses and permits,[11] and with respect to permissible financing delays, the Notice removes the qualification that the financing delay be less than six months.[12]

PHYSICAL WORK TEST

In the Notice, the IRS reiterates that as provided in Section 3 of Notice 2014-46, the physical work test focuses on the nature of the work performed, not the amount of work or the cost. The Notice goes on to provide that if the work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold required under the physical work test.[13]

To illustrate physical work of a significant nature for different renewable energy facilities, the following non-exclusive examples are provided in the Notice[14]:

(a) *Wind Facilities*. The excavation for the foundation, the setting of anchor bolts into the ground, or the pouring of concrete pads of the foundation.

(b) *Hydropower Facilities*. The excavation for or construction of a penstock, power house, or retaining wall structure.

(c) *Biomass and Trash Facilities*. The performance of site improvements (as opposed to site clearing), such as filling or compacting soil, or installing stack piling.

(d) *Geothermal Facilities*. Physical activities that are undertaken at a project site after a valid discovery.

The IRS also reiterates that as provided in Section 4.02(1) of Notice 2013-29, physical work of a significant nature does not include preliminary activities, even if the cost of those preliminary activities is properly included in the depreciable basis of the facility.

[9] Notice 2016-31, § 3.02(2).

[10] Notice 2016-31, § 3.02(2)(e) and (f).

[11] Notice 2016-31, § 3.02(2)(c).

[12] Notice 2016-31, § 3.02(2)(j).

[13] Notice 2016-31, § 5.01.

[14] Notice 2016-31, § 5.02.

The Notice includes a non-exclusive list of preliminary activities, substantially identical to the list provided in Notice 2013-29.[15]

With respect to the definition of a "facility" for purposes of the Notice, and consistent with Notice 2013-29, the Notice provides:

(a) That a facility generally includes all components of property that are functionally interdependent (i.e., the placing in service of each component is dependent upon the placing in service of each of the other components in order to generate electricity).[16]

(b) Multiple facilities that are operated as a part of a single project will be treated as a single facility and this single-project rule may be applied whether a facility is relying on the physical work test or 5% safe harbor. Further, whether multiple facilities are operated as a single project and therefore treated as a single facility will depend on the relevant facts and circumstances and the determination must be made in the calendar year during which the last of the multiple facilities is placed in service.[17]

Under the Notice, whether relying upon the physical work test or the 5% safe harbor, multiple facilities that are treated as a single facility for purposes of determining whether construction of a facility has begun may be disaggregated and treated as multiple separate facilities for purposes of determining whether a facility satisfies the continuity safe harbor.[18] The disaggregated facilities that are placed in service by the continuity safe harbor deadline will be eligible for the continuity safe harbor and those that are not may satisfy the continuity safe harbor under a facts and circumstances determination.

To illustrate how the disaggregation rule is intended to work, the following example is provided in the Notice:

> Example. X is developing a wind farm that will consist of 50 turbines, associated towers and supporting pads, a computer system that monitors and controls the turbines, and associated power conditioning equipment. The entire wind farm will be connected to the power grid through a single intertie, and power generated by the wind farm will be sold to a local utility through a single power purchase agreement. Using the single project rule in Section 5.04(2), the entire wind farm is a single project that will be treated as a single facility. On June 1, 2018, X excavates the site for the foundations of 10 of the 50 turbines and pours concrete for the supporting pads. Accordingly, X has performed physical work of a significant nature that constitutes the beginning of construction of the single facility for purposes of Code sections 45 and 48.

[15] Notice 2016-31, § 5.03.

[16] Notice 2016-31, § 5.04(1).

[17] Notice 2016-31, § 5.04(2) and (3).

[18] Notice 2016-31, § 5.04(4).

> Thereafter, X places in service only 40 of the 50 turbines and related facilities before January 1, 2023. X disaggregates the 50 turbines under Section 5.04(4). Forty of the 50 turbines satisfy the continuity safe harbor. For the remaining 10 turbines, X may demonstrate that it satisfies the continuous construction test described in Section 4.06 of Notice 2013-29 based on the facts and circumstances.[19]

APPLICATION OF THE 5% SAFE HARBOR TO RETROFITTED FACILITIES

Finally, the Notice provides that a facility comprised in part of used property may qualify as originally placed in service, provided that the fair market value of the used property is not more than 20% of the facility's total value (the "80/20 rule").[20] In the case of a single project comprised of multiple facilities, the 80/20 rule is applied to each individual facility. Further, the 5% safe harbor is applied only with respect to the cost of new property (*i.e.*, only expenditures paid or incurred that relate to new construction are taken into account).[21]

To illustrate the application of the 5% safe harbor to retrofitted facilities, the following example is provided in the Notice:

> Example. Taxpayer owns an existing wind farm comprised of 13 turbines, pads, and towers for which the eligibility periods for the PTC or the ITC have elapsed. Each facility has a fair market value of $1 million. Taxpayer replaces components worth $900,000 at each of 11 of the facilities at a cost of $1.4 million for each facility. Two of the 13 facilities are not upgraded. The fair market value of the remaining original components at each of the upgraded facilities is $300,000. The total expenditure to retrofit the 11 facilities is $15.4 million ($1.4 million x 11). Taxpayer applies the single project rule provided in Section 5.04(2).
>
> The fair market value of the remaining original components of each individual upgraded facility ($300,000) is not more than 20% of each facility's total value of $1.7 million (the cost of the new components ($1.4 million) plus the value of the remaining original components ($300,000)). Thus, each upgraded facility will be considered newly placed in service for purposes of Code sections 45 and 48. Accordingly, if the taxpayer pays or incurs at least

[19] Notice 2016-31, § 5.04(a).

[20] Notice 2016-31, § 6.01.

[21] Notice 2016-31, § 6.02.

$770,000 (5% of $15.4 million) of qualified expenditures in 2016, construction of the single facility will be considered to have begun in 2016, and if the taxpayer also satisfies the continuous efforts test, each of the 11 upgraded facilities will be a qualified facility within the meaning of Code section 45(d). No additional PTC will be allowed with respect to energy produced by the taxpayer at the two facilities that were not upgraded. Nor will those two facilities qualify for additional ITC.[22]

[22] Notice 2016-31, § 6.02(1).

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