Akin

IRS Finally Releases Clarifications to PTC “Start of Construction” Guidance

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I. Clarification of Physical Work of a Significant Nature

The IRS in Notice 2013-29 provided two options for a project to be deemed to have met the statutory standard for tax credits of starting construction in 2013. Five percent of the ultimate total cost of the project could be incurred in 2013 to meet a safe-harbor. Alternatively, if a project did not meet the 5 percent safe-harbor in 2013, it could still be deemed to have started construction in 2013 if “physical work of a significant nature” was undertaken in 2013 (the “Physical Work Test”).

Notice 2013-29 provided examples of such work that included excavating a foundation, pouring concrete for a foundation, installing anchor bolts, building integral roads and working on a custom-designed step-up transformer (the “Examples of Significant Work”). However, Notice 2013-29 also included an example in which 20 percent of the turbine site’s excavation was completed, concrete was poured and anchor bolts installed. This example created a concern that the Physical Work Test arguably required satisfaction of a 20 percent threshold.

Notice 2014-46 puts that concern to rest. It provides that the 20 percent example was “not intended to indicate that there is a 20 percent threshold or minimum amount of work required to satisfy the Physical Work Test. Assuming the work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold required to satisfy the Physical Work Test.” The foregoing statement could appear to raise the question: Although there is no fixed minimum, how does a project owner know that the work done was “of a significant nature”?

Notice 2014-46 provides clear comfort on that issue. With respect to the Examples of Significant Work, it provides "Beginning work on any of the activities described above will constitute physical work of a significant nature." The word "beginning" seems particularly helpful as it makes it clear that the Examples of Significant Work need not have been completed in 2013.

II. Transfers of Grandfathered Projects

The industry had requested that the IRS clarify that a developer could "start construction" in 2013 to qualify its project for tax credits and then sell or otherwise transfer the project to another party.[2] The guidance in Notice 2014-46 is more restrictive than what the industry requested.

The notice provides that a transfer is permissible, so long as either (a) the transferor or transferee is at least 20 percent related[3] or (b) the property transferred does not consist "solely of tangible property (including contractual rights to such property under a binding written contract)." Although not expressly referenced, the 20 percent option is similar to the principles of FAQ 23 of Treasury's Begun Construction Cash Grant[4] guidance, while the option to transfer more than merely tangible property is similar to the principles of FAQ 24 of that guidance.[5] However, Notice 2014-46 is far more opaque in this respect than the Treasury FAQs.

For instance, FAQ 23 provides that the 20 percent related requirement applies "immediately before or immediately after," while the notice is silent as to how long the parties must remain related. Further, FAQ 24 has an example in which safe-harbor equipment is transferred along with "permits, a power purchase agreement and an interconnection agreement," and the FAQ confirms that is sufficient, while no example is included in the notice. Nonetheless, it would seem reasonable that transfer of the equipment for a project along with permits, a power purchase agreement and an interconnection should be sufficient for tax credit grandfathering purposes. Further, if the project is intended to be merchant, the power purchase agreement should not be required.

In addition, as land rights are not "tangible personal property," it should be permissible to transfer the grandfathered equipment along with only title to land for the project, a leasehold interest in land for the project or an option to acquire either of the foregoing.

What the government has communicated in its concern with respect to transfers of grandfathered equipment under the Cash Grant program was "trafficking" in grandfathered equipment, i.e., a financial investor purchasing equipment prior to the tax credit deadline, with little or no intent in actually developing a project, and then selling the equipment for a premium to a buyer seeking to qualify a project for tax credits. The trafficking concern should not be present so long as contracts that require time and expense to acquire, such as interconnection and power purchase agreements, are transferred with the tangible personal property.

III. Five Percent Safe-Harbor Clarification

Although not requested by the wind industry, the notice clarifies what happens if the amount incurred for a project in 2013 turns out to be less than 5 percent of the ultimate "total cost of the project." The notice provides that, if the project is composed "of multiple facilities" (e.g., multiple wind turbines), the tax credit eligible portion can just be reduced until "total cost" of the tax credit eligible portion is not in excess of 20 times the amount incurred in 2013. The notice has an example in which only three of five turbines in a wind project are deemed to be tax credit eligible due to the total cost of all five turbines exceeding 20 times the amount incurred in 2013.[6]

What the notice does not clarify is how to handle the cost of improvements that are used by both the tax credit eligible and the tax credit ineligible portion, such as roads and transformers. Must such common improvements be completely attributed to the tax credit eligible portion? Or can the cost of such common improvements be prorated between the tax credit eligible and the tax credit ineligible portions? Prorating would appear to be the more equitable, but possibly not permissible, as transmission and most roads are "integral" to the tax credit eligible portion of the project.[7]

Although the notice is opaque in certain areas it should be welcomed by the wind industry. The notice should result in many wind projects that were on hold moving forward at an expedited pace.

Projects will need to be on an accelerated schedule in order to be "placed in service" by the end of 2015 as is necessary to avoid scrutiny from the IRS regarding whether they were "continuously constructed" from January 2014 forward. As the notice was released almost three months after it was first previewed by a Treasury lawyer at a bar association meeting,[8] it would have been equitable if notice had also shifted the deadline to avoid continuous construction scrutiny from December 31, 2015, to March 31, 2016. As such a deadline is not statutorily mandated, it would have been in the IRS's discretion to grant such leniency.

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[1] A Treasury lawyer speaking at an American Bar Association conference on May 9 had summarized the industry's requests. A blog post discussing the Treasury lawyer's statements is available here.

[2] This issue arises whether "start of construction" was deemed to occur by satisfying the 5 percent safe-harbor or by meeting the Physical Work Test in 2013.

[3] The notice refers to Internal Revenue Code Section 197(f)(9)(C), which provides a 20 percent standard.

[4] The Cash Grant is provided for in Section 1603 of division B of the American Recovery and Reinvestment Act, as amended. For wind and solar projects, the Cash Grant is 30 percent of "eligible basis." Solar projects have until the end of 2016 to be "placed in service"; however, a preliminary Cash Grant application must have been filed before the end of 2012. Wind projects must have been placed in service before the end of 2012.

[5] The guidance is available here.

[6] The notice has a second example involving a biomass facility that cannot be divided into multiple facilities; thus, the biomass facility, if it missed the 5 percent safe-harbor, is only tax credit eligible if it met the Physical Work Test in 2013.

[7] *See* Section 5.01(1) of Notice 2013-29 (defining "total cost" as "All costs properly included in the depreciable basis of the facility are taken into account to determine whether the Safe Harbor has been met. The total cost of the facility does not include the cost of land or any property not integral to the facility.").

[8] *See* note 1, *supra*.

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