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The state of play

Beginning construction on PTC projects in 2013

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In January, Congress amended the section 45 renewable electricity production tax credit (PTC) and the election to claim the energy investment tax credit (ITC) in lieu of the PTC to apply to facilities on which construction begins before January 1, 2014. This opportunity is available for a number of renewable energy technologies, including wind, biomass, and geothermal. In recent months, the IRS has issued two notices – Notice 2013-29 and Notice 2013-60 – providing guidance on how to ensure that projects can be treated as beginning construction this year and be grandfathered into eligibility for the PTC or the ITC.

Two ways to show that construction has begun

The IRS has created two methods for taxpayers to show that they have begun construction. Overall, the approach is similar to that used by Treasury in the section 1603 cash grant program, but there are significant differences companies should note when planning their project development schedules.

1. Physical Work of a Significant Nature

The IRS will conclude that construction of a qualified facility begins when physical work of a significant nature begins. The work may be performed by the facility owner or by other persons under binding written contract.

Preliminary activities, such as planning, designing, surveying, etc., are not considered to be physical work of a significant nature. Physical work performed off-site, however, if otherwise meeting the standard, may suffice, such as the assembly of components by a vendor under a binding written contract.

The physical work must also relate to property that is integral to the activity to be performed by the facility, such as electricity generation.

Once physical work of a significant nature is begun, the facility owner must maintain a continuous program of construction, but some disruptions that are beyond the facility owner's control (e.g., natural disasters, severe weather, labor stoppages, or regulatory delays) generally will not cause a failure to maintain a continuous program of construction.

2. "Five-Percent" Safe Harbor

Alternatively, the IRS will conclude that construction of a facility has begun when the facility owner pays or incurs five percent or more of the total cost of the facility. Costs that are incurred by other persons under binding written contract may be taken into account in determining the total costs paid or incurred (the "look-through" provision).

Similar to the physical work standard, the IRS will require facility owners to maintain continuous efforts towards completion once the five percent cost threshold has been reached. After discussion and feedback from project developers and advisors, the IRS has now provided a bright-line rule that this continuous efforts requirement will be deemed met as long as the project is placed into service by the end of 2015.

The IRS also provides the same recognition that some events may occur beyond the control of the facility owner that could disrupt progress towards completion.

In addition, the IRS notes that cost overruns of facilities may result in the safe harbor not being met, as the initial costs incurred will no longer meet or exceed five percent of the larger total cost of the facility. If the facility is comprised of units that may be seen as smaller independent facilities themselves, the safe harbor could apply to a portion of those facilities where the aggregate total cost is no more than twenty times the initial costs incurred.

What does this mean for renewable energy developers?

Companies, joint ventures, and others interested in pursuing the PTC or ITC now have a choice to make in determining how to structure and document the beginning of their project. The IRS has stated that a facility owner need only meet either test to establish qualification, but in practice many companies are likely to work toward meeting both standards to ensure tax credit eligibility.

Under the physical work standard, the IRS will apply a "facts and circumstances" test to distinguish between preliminary activities and significant activities, to determine whether property is integral to the facility, and to evaluate whether construction has been continuous.

The 5% safe harbor, while based on objective calculations, nevertheless is vulnerable to cost overruns and, for projects with longer construction timelines, inherent uncertainty about what constitutes "continuous efforts" to develop a project that will not be completed until 2016 or later.

Both methods contain a "look through" provision where the activity of or costs incurred by third parties may be used to satisfy the standard. These both rely on the presence of a valid contract that will be respected by the IRS as well as the verification of the actions of the third party. In addition, the 5% safe harbor requires that liquidated damages provisions in third-party contracts call for the buyer to pay at least 5% of project costs. Although the Notice provides some relief for events outside the taxpayer's control, that does not extend to other common project issues such as third-party delays in completing transmission lines or delays caused by the bankruptcy of a supplier or contractor.

In practice, companies will need to evaluate carefully how to show a plan of continuous construction or continuous effort to complete their projects and how to protect themselves contractually from risks relating to third-party delays. Many companies may wish to consider approaching the IRS or their tax advisors for additional guidance on these topics so they can make PTC-related representations to their lenders or potential project buyers with greater confidence.

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