

New PTC beginning of construction guidance

Introduction

The Internal Revenue Service (“IRS”) and U.S. Department of Treasury (“Treasury”) released Notice 2017-04 on December 15, 2016, clarifying prior guidance related to the production tax credit (“PTC”) and investment tax credit (“ITC”) in lieu of PTC with just weeks left in the year. As 2016 winds down, some taxpayers are rushing to begin constructing renewable energy projects that use wind, biomass, geothermal, hydropower and waste resources to generate electricity in order to remain eligible for federal incentives that are phasing down or expiring after year-end. This new guidance provides added certainty to taxpayers planning to grandfather or “re-start” construction in 2016 on projects that may have started in earlier years in order to qualify for a 100-percent value PTC or ITC in lieu of PTC. user configurable calculations.

Notice 2017-04:

Notice 2017-04¹ principally addresses three tax technical issues that emerged as issues of concern for taxpayers after the IRS issued prior guidance in early 2016, Notice 2016-31².

1) Retroactivity

Prior to 2016-31, projects had a two-year “Continuity Safe Harbor” period in which taxpayers could place projects in service without the need to prove under facts and circumstances that the taxpayer began construction and continued thereon with construction activities until completion. The two-year Continuity Safe Harbor period began on the tax credit termination date, regardless of the actual date on which the taxpayer began construction. Following

a multi-year extension and phaseout of the PTC and ITC in lieu of PTC enacted by Congress in 2015, the IRS issued Notice 2016-31, revising the two-year Continuity Safe Harbor by providing that a facility will be considered to satisfy the Continuity Safe Harbor if a taxpayer places a facility in service by the later **of four** calendar years from the calendar year during which construction of the facility began **or December 31, 2016**. This change requiring measurement from the actual year in which construction began had the unintended consequence of rendering ineligible certain projects that started construction in 2013 (or earlier) that could not be completed and placed in service before December 31, 2017 (or earlier).

Notice 2017-04 adopted a simple “fix” by changing a single date in the preceding guidance. The notice provides that a taxpayer will be deemed to satisfy the Continuity Safe Harbor if a project is placed in service by the later **of four** calendar years following the calendar year in which construction began **or December 31, 2018**.³ This change allows taxpayers that started construction in 2013 or earlier, to be placed in the same position they would have been under prior guidance had Notice 2016-31 simply rolled forward the prior guidance’s two-year Continuity Safe Harbor.

2) Alternating Methods

The new notice also addresses the prohibition first created in Notice 2016-31 that barred taxpayers from alternating between methods to begin construction (i.e., beginning physical work in Year 1 and then incurring 5% of project costs in Year 2) in order to extend their safe harbor period.

Notice 2017-04 provides that this rule will only apply prospectively to facilities the construction of which begins after June 6, 2016, the official publication date of Notice 2016-31.⁴

3) Repowering

Finally, the notice clarifies that for purposes of wind facility ‘repowering’ and, specifically, the “80/20 Rule,” the “cost of new property” includes “all costs properly included in the depreciable basis of the new property.”⁵ In recent years, many taxpayers have considered refurbishing old wind farms in order to be considered a new facility for PTC purposes and start a new PTC credit period. Under the 80/20 Rule, discussed herein, a taxpayer is required to compare the costs of new property relative to the value of any used property that will remain at the facility. The notice provides some clarity to taxpayers as they calculate various repowering scenarios for particular components that may be added existing wind facilities.

Background of PTC and ITC in Lieu of PTC

On December 18, 2015, President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”) and Consolidated Appropriations Act of 2015 (together “Tax Extenders”).⁶ Among the extended provisions were the PTC for wind and other qualifying renewable energy technologies under section 45 of the Internal Revenue Code (“IRC”) and the ITC in lieu of the PTC under section 48.⁷ Tax Extenders extended the PTC for two years with respect to certain facilities (e.g., biomass, geothermal, hydropower and waste-to-energy) the construction of which must begin before

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January 1, 2017, and further extended for five years the PTC for wind facilities the construction of which must begin before January 1, 2020. The Tax Extenders also modified the PTC for wind facilities by providing that the credit will phase out between 2017 and 2020. Under current law, a taxpayer may claim 100 percent of the value of PTCs or the ITC in lieu of PTC on a new qualified wind facility only if construction of the facility begins (the "Begun Construction" requirement) before January 1, 2017. Thereafter, the value of the credit phases down 20 percent each year until the credit phases out completely for any new facilities that begin construction after December 31, 2019.

Addressing Tax Extenders in 2012, Congress modified the eligibility requirements of the PTC and ITC in lieu of PTC to substitute the "placed in service" standard with the Begun Construction standard.⁸ Congress made clear to the IRS its intention was to use the definition of Begun Construction that was used in the 1603 Grant Program, and those rules in turn were borrowed from bonus depreciation, bond-financing and ITC rules dating back to the 1960s.⁹ Since the Begun Construction requirement was first enacted in early 2013 for purposes of the PTC and ITC in lieu of PTC, the IRS has promulgated six guidance documents to define and clarify the requirements for the new standard: Notices 2013-29, 2013-60, 2014-46, 2015-25, 2016-31 and now, 2017-04 (collectively, the "IRS notices").

A. Notice 2013-29 and Notice 2013-60

To satisfy the Begun Construction Requirement, IRS guidance requires that the taxpayer prove that prior to the statutory credit deadline, it commenced "physical work of a significant nature" on the facility ("Physical Work Test") or incurred at least 5 percent of the total cost of the facility ("5% Safe Harbor").¹⁰ Thereafter, and until the facility is placed in service, the taxpayer must also prove that it maintained a "continuous program of construction" to satisfy the Physical Work Test¹¹ or made "continuous efforts to advance towards completion of the facility"

to satisfy the 5% Safe Harbor (collectively, the "Continuity Requirement").¹²

In this earlier IRS guidance, if the facility was placed in service within two calendar years of the statutory deadline to begin construction, the taxpayer was deemed automatically to have satisfied the "continuous program of construction" or "continuous efforts" requirement, as the case may be¹³ (collectively, and as referred to above, the "Continuity Safe Harbor"). If the facility was not placed in service within two calendar years, however, whether the taxpayer satisfied the "continuous program of construction" or "continuous efforts" requirement, whichever applies, would be determined based on all relevant facts and circumstances, some of which are described in sections 4.06 and 5.02 in Notice 2013-29.

Section 4.06 of Notice 2013-29 provided that "a continuous program of construction involves continuing physical work of a significant nature (as described in section 4.02)." Whether a taxpayer maintains a continuous program of construction will be determined by the relevant facts and circumstances.¹⁴ Certain disruptions during the construction of a facility that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to maintain a continuous program of construction ("Excusable Disruptions").¹⁵

B. Notice 2014-46

The IRS clarified the Physical Work Test in Notice 2014-46.¹⁶ In emphasizing that "[t]his test focuses on the nature of the work performed, not the amount or cost," the IRS provided a non-exclusive list of activities that will satisfy the Physical Work Test.¹⁷

1. The beginning of the excavation for the foundation;
2. The setting of anchor bolts into the ground;
3. The pouring of the concrete pads of the foundation;
4. Physical work on a custom-designed transformer that steps up the voltage of electricity produced at the facility to the voltage needed for transmission; and

5. Starting construction on onsite roads that are used for moving materials to be processed (for example, biomass) and roads for equipment to operate and maintain the qualified facility.

The IRS followed this list of enumerated activities with the conclusive statement, "[b]eginning work on any one of the activities described above will constitute physical work of a significant nature"¹⁸. Notice 2013-29 also elaborates further with regard to off-site activities beyond the manufacture of a custom-designed step-up transformer where commencing the manufacture of component property will constitute physical work of a significant nature:

6. If the facility's wind turbines and tower units are to be assembled on-site from components manufactured off-site by a person other than the taxpayer and delivered to the site, physical work of a significant nature begins when the manufacture of the components begins at the off-site location, but only if (i) the manufacturer's work is done pursuant to a binding written contract (as described in section 4.03(1)) and (ii) these components are not held in the manufacturer's inventory (as described in section 4.02(2)). If a manufacturer produces components for multiple facilities, a reasonable method must be used to associate individual components with particular facilities.¹⁹ In clarifying an example from Notice 2013-29, in which site excavation and concrete pouring occurs at 10 of 50 turbine sites, the IRS said that the example was "not intended to indicate that there is a 20% threshold or minimum amount of work required to satisfy the Physical Work Test."²⁰

The language in Notice 2014-46 provides: "[a]ssuming 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.²¹ Furthermore, the notice also provides that if a facility is placed in service before the end of the Continuity Safe Harbor period, the taxpayer may rely on 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” between the credit termination deadline and the end of the Continuity Safe Harbor period.²²

C. Notice 2015-25

In response to a one-year extension of the PTC and ITC in lieu of PTC by Congress in December of 2014²³, the IRS issued Notice 2015-25 that primarily extended by one year the deadlines in all previous notices and extended by one year the deadline for satisfaction of the Continuity Safe Harbor.²⁴ That is, if a taxpayer began construction of a facility prior to the newly-enacted statutory credit deadline and placed the facility in service within Continuity Safe Harbor period, the facility would 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 within the Continuity Safe Harbor period.

D. Notice 2016-31

Following the multi-year extension and phaseout of the PTC and ITC in lieu of PTC enacted by Congress in 2015, the IRS issued Notice 2016-31 to significantly modify the Begun Construction requirement.²⁵ As discussed above, the IRS revised the two-year Continuity Safe Harbor by providing that a facility will be considered to satisfy the Continuity Safe Harbor if a taxpayer places a facility in service by the later of four calendar years from the calendar year during which construction of the facility began or December 31, 2016. The guidance retroactively applied this standard to all facilities that began construction prior to issuance of the guidance.²⁶ Moreover, the 2016 guidance prohibited a taxpayer

from relying upon the Physical Work Test and the 5% Safe Harbor in alternating calendar years to satisfy either the begun construction requirement or the Continuity Requirement.²⁷ If a facility is not placed in service within four calendar years, whether the taxpayer satisfied the “continuous construction” or “continuous efforts” requirements, whichever applies, is determined based on all relevant facts and circumstances, some of which are described in sections 4.06 and 5.02 in Notice 2013-29, as expanded by section 4.02 of Notice 2016-31.

Notice 2016-31 modified the list of Excusable Disruptions and added the following disruptions: interconnection-related delays; delays in the manufacture of custom components; and financing delays (previously, financing delays must have been for a period of six months or less).

Notice 2016-31 reiterated that multiple facilities that are operated as part of a single project (along with any property, such as a computer control system, that serves some or all such facilities) will be treated as a single facility solely for purposes of the Begun Construction requirement (the “Aggregation Rule”). This notice requires that the taxpayer make its Aggregation Rule determination for Begun Construction purposes in the calendar year during which the last of the multiple facilities is placed in service.²⁸

In addition, Notice 2016-31 provided that multiple facilities that are operated as part of a single project and treated as a single facility for purposes of determining whether construction of a facility has begun may subsequently be disaggregated and treated as multiple separate facilities for purposes of determining whether a facility satisfies the Continuity Safe Harbor (the “Disaggregation Rule”). Disaggregated facilities placed in service prior to the Continuity Safe Harbor deadline will be eligible for the Continuity Safe Harbor. The remaining disaggregated facilities not placed in service prior to the Continuity Safe Harbor deadline may still satisfy the

Continuity Requirement under a facts and circumstances determination.²⁹ This new provision in the Begun Construction guidance provided additional flexibility to developers constructing large projects with long construction schedules. The Disaggregation Rule may be applied to facilities that rely upon either the Physical Work Test or the 5% Safe Harbor to satisfy the Continuity Requirement.

Notice 2017-04 Clarifies Notice 2016-31

Despite the four-year Continuity Safe Harbor period provided to the wind industry and taxpayers developing other projects from renewable resources, the wind industry had expressed concern with the retroactivity of the four-year period and other language that appeared in Notice 2016-31.³⁰ The IRS and Treasury recognized those concerns and quickly began working on clarifying guidance, in addition to parallel guidance for taxpayers beginning construction on solar energy property, as the statutory framework for the ITC for solar also adopted a Begun Construction requirement and differs from the PTC in several technical areas.³¹

Notice 2016-31 provided that a taxpayer would satisfy the Continuity Safe Harbor if the taxpayer placed its project into service by the later of four calendar years from the end of the year in which construction began or December 31, 2016. This led to a result that would negatively impact some taxpayers’ PTC or ITC in lieu of PTC eligibility, changing the Continuity Safe Harbor standard by providing a limitation on projects that were incentivized to begin construction in earlier years such as 2011, 2012, or 2013. Previous notices provided taxpayers that began construction in 2011 or later a two-year window to place facilities in service beginning on the credit termination date. For example, a taxpayer that began construction in 2011 could place the facility in service before January 1, 2017 and still comply with the Continuity Safe Harbor as expressly provided under Notice 2015-25. Under Notice 2016-31, however, the taxpayer would be outside of the Continuity Safe Harbor and prove

continuity under facts and circumstances all the way back to 2011.

In demonstrating continuity through facts and circumstances, some in the wind industry had suggested that the IRS and Treasury clarify some lingering uncertainty regarding the determination of whether a foreseeable construction disruption is nonetheless considered an Excusable Disruption for purposes of the continuous construction and continuous efforts tests under section 4.02(2) of Notice 2016-31. Notice 2017-04 did not go so far as to clarify with regard to the application of the Excusable Disruption rules and examples in Notice 2016-31 that the likelihood or foreseeability of the disruption occurring during the facility's construction is irrelevant. The Excusable Disruption rule could be clarified by applying a rule similar to the single project determination, such that Excusable Disruptions must be determined in the calendar year during which the facility is placed in service or, in the case of a single project, during the calendar year in which the last of the multiple facilities is placed in service, without regard to the foreseeability of the disruption during the construction period.

Lastly, Notice 2016-31 prohibits relying on both the Physical Work Test and 5% Safe Harbor in alternating calendar years, which generated significant interest on the part of taxpayers to "re-start" construction in a later calendar year to maximize PTC project opportunities and remain in compliance with the revised Continuity Safe Harbor. Even after Notice 2017-04, this prohibition remains in effect with regard to certain facilities the construction of which begin after June 6, 2016. However, what is not explicitly clear in Notice 2017-04 is exactly how this prohibition should apply with regard to facilities the construction of which may be viewed as beginning both before and after June 6, 2016. For example, if the construction of a facility is determined to have begun in December 2016 under the 5% Safe Harbor, while at the same time satisfying the Physical Work Test in an earlier calendar year, does the

prohibition against combining methods still apply requiring the taxpayer to measure the application of the Continuity Safe Harbor from the end of the earlier calendar year when physical work was started? Alternatively, would the application of this rule simply no longer apply with respect to the same project if the 5% Safe Harbor was satisfied before June 7, 2016, rather than after June 6, 2016?

One would have generally expected this rule to apply the same way to similarly situated taxpayers that satisfy the 5% Safe Harbor at any time during calendar year 2016. Nevertheless, it is widely believed that the prohibition against combining methods rule only applies prospectively to facilities that begin construction under both the Physical Work Test and 5% Safe Harbor after June 6, 2016. Since the prohibition against combining methods in alternating calendar years did not exist in prior Begun Construction guidance, the effect of the new rule should not be binding on facilities the construction of which began under either method prior to June 7, 2016.

Conclusion

The IRS and Treasury have now provided six notices to clarify the Begun Construction requirement for purposes of the PTC and ITC in lieu of PTC. As new questions arise in transactions in the midst of new legislation, new technology and new economic realities, each issuance of published guidance clarifies certain issues while bringing to light others. Industry and tax professionals are likely to grapple with eligibility and compliance questions through the end of 2016 and beyond. It is important for taxpayers to review their contractual arrangements with project parties, and stay in regular contact with manufacturers and other vendors to monitor compliance with activity documentation protocols. No details are minor, and no questions are unimportant in the efforts to begin construction and remain compliant with PTC and ITC in lieu of PTC eligibility.

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Endnotes

1. 1 Notice 2017-04, 2017-3 I.R.B. 1.
2. 2 Notice 2016-31, 2016-23, I.R.B. 1025.
3. 3 Notice 2017-04 at section 3.
4. 4 Id. at section 4.
5. 5 Id. at section 5.
6. 6 Pub. L. No. 114-113, 129 Stat 2242 (2015).
7. 7 Id. at Division Q, sections 301, 302.
8. 8 The American Taxpayer Relief Act of 2012 ("ATRA"), Pub. L. No. 112-240, § 407, 126 Stat. 2313 (2013).
9. 9 Based on public comments by IRS attorneys. See e.g., Madara, "Official Provides Insight on Recent Energy Construction Guidance," Tax Notes, Sept. 1, 2014, p. 1033.
10. 10 Notice 2013-29, 2013-20 I.R.B. 1085, at section 3.
11. 11 Id. at section 4.01.
12. 12 Id. at section 5.01.
13. 13 Notice 2013-60, 2013-44 I.R.B. 431, at section 3.02.
14. 14 Notice 2013-29 at section 4.06(1).
15. 15 Id. at section 4.06(2).
16. 16 Notice 2014-46, 2014-35 I.R.B. 1, at section 3.
17. 17 Id.
18. 18 Id.
19. 19 Id.
20. 20 Id.
21. 21 Notice 2014-46 at section 3.
22. 22 Id. at section 2.
23. 23 The Tax Increase Prevention Act of 2014 ("TIPA"), Pub. L. No. 113-295 (2014) at section 155.
24. 24 Notice 2015-25, 2015-13 I.R.B. 814.
25. 25 Notice 2016-31, 2016-23 I.R.B. 1025.
26. 26 Id. at section 7. The guidance is effective beginning on January 3, 2013.
27. 27 Notice 2016-31 at section 4.01 (providing by 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 Continuity Safe Harbor will be applied beginning in 2015, not in 2016).
28. 28 Id. at section 5.04(3).
29. 29 Id. at section 5.04(4).
30. 30 Tax Notes Today, ABA Section of Taxation Meeting: 'Begin Construction' Energy Credit Guidance May Get Tweaks, Luca Gattoni-Celli and Matthew Madara, May 16, 2016.
31. 31 Id. See also Department of the Treasury 2016-2017 Priority Guidance Plan (first quarter updated), General Tax Issues No. 14, Guidance on the modification, extension, and phase out of the investment tax credit (ITC) for solar energy property under §48, Oct. 31, 2016.

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