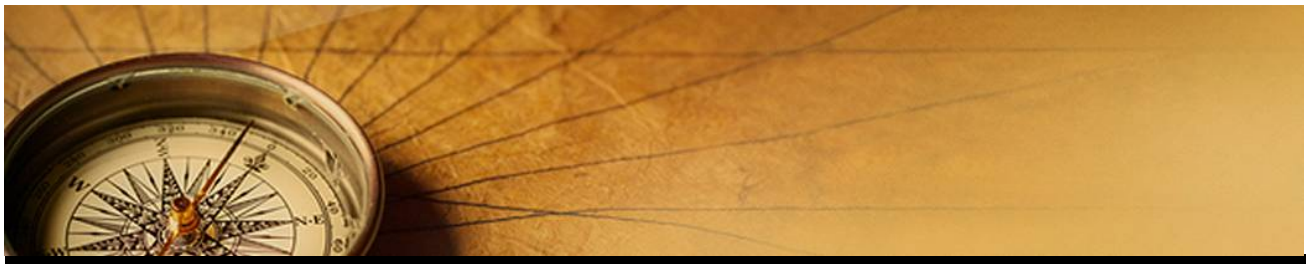

ML Strategies Legislative Update

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IRS Issues "Begin Construction" Guidance for Renewable Energy Tax Credits

On April 15, 2013, the Internal Revenue Service (IRS) issued long-awaited guidance updating eligibility requirements for renewable project developers seeking to utilize the 2.3 cent / kWh Renewable Electricity Production Tax Credit (PTC) or a 30 percent investment tax credit (ITC) in lieu of the PTC.

When Congress extended the credits a few months ago, it made significant changes to the eligibility criteria for the PTC and ITC by requiring that qualified facilities merely *begin construction* before January 1, 2014, rather than be placed in service by that time. This recent guidance, released as IRS Notice 2013-29, clarifies what activities constitute beginning construction.

How Are Qualified Facilities Defined?

Under 26 U.S.C. §45(d) and §48(a)(5), qualified facilities eligible for the PTC or ITC include wind, closed-loop biomass, open-loop biomass, geothermal, landfill gas, trash, hydropower, and marine and hydrokinetic facilities.

Ordinarily, for PTC and ITC purposes, each qualified facility is treated as a separate facility. However, consistent with its treatment for the 1603 Grant-in-Lieu-of-Tax Credit Program, the IRS will treat multiple facilities comprised of individual, but interdependent generating assets—such as wind farms—as single facilities so long as key factors are met. This is an especially welcome development for wind developers, who otherwise would have had to begin construction on each turbine by January 1, 2014 in order for the entire project to qualify for the PTC. The listed factors are:

(a) The facilities are owned by a single legal entity;
(b) The facilities are constructed on contiguous pieces of land;

(c) The facilities are described in a common power purchase agreement or agreements;
(d) The facilities have a common intertie;
(e) The facilities share a common substation;
(f) The facilities are described in one or more common environmental or other regulatory permits;
(g) The facilities were constructed pursuant to a single master construction contract; and
(h) The construction of the facilities was financed pursuant to the same loan agreement.

When Does Construction Begin?

Like the Section 1603 Program, the new PTC guidance provides taxpayers two methods for establishing a facility has begun construction by January 1, 2014:

1. "Starting physical work of a significant nature", and/or

2. Showing a developer incurred "at least" five percent of total project costs, pursuant to the "safe harbor" provisions of the guidance.

A taxpayer need only satisfy the requirements of one method for a facility to qualify for the PTC or ITC. The IRS also provides flexibility in implementing the new guidance, noting it will take case-by-case approach to determining if a facility is eligible for the PTC or ITC based on the "relevant facts and circumstances."

1. Physical Work of a Significant Nature

The IRS will take a broad view as to what constitutes "physical work of a significant nature," recognizing how and in what order renewable energy facilities are developed varies significantly by technology and geography.

When Will the IRS Recognize Work Has Begun?

The IRS enumerates several activities representing "beginning construction" such as foundation excavation, the setting of anchor bolts into the ground, or the pouring of the concrete pads of the foundation as "significant" work, whether done by the taxpayer or a contractor. The offsite manufacture of project components can also constitute "beginning construction," as discussed below.

Where Does the Physical Work Have to Occur?

Both on-site and off-site work performed by the taxpayer or by another entity on behalf of the taxpayer may constitute beginning construction, so long as there exists a "binding written contract." Off-site work is only eligible if it done after a binding equipment order has been placed with the manufacturer. In other words, a developer cannot count work previously done for an off-the-shelf item toward this physical work requirement.

What Contracts Are Considered Binding?

Under the new guidance, "binding written contracts" must be enforceable under local law, have no liquidated damages (or similar) clause, and been entered into prior to performance. Previously, the IRS has considered contracts binding so long as the contract does not limit damages to which the parties are exposed after a breach to less than five percent of the total contract price. The IRS may further clarify its position on liquidated

damages provisions.

What Kinds of Work Are Not Considered "Significant"?

Certain enumerated activities are characterized as preliminary (and therefore not significant) activities under the new guidance, even if the cost of those activities can be included in the depreciable basis of the facility. Preliminary activities include a) planning or designing; b) obtaining financing; c) exploring; d) researching; e) securing permits and licenses, f) conducting environmental and engineering surveys or studies; g) clearing a site; h) test drilling of geothermal deposits or soil; or h) excavation to modify the contour of the land.

Also, any significant work must also be considered *integral* to the project. For example, constructing fences around a project site are not characterized as integral under the new guidance. Similarly, constructing an onsite transmission tower is also not considered physical work of a significant nature for PTC purposes because the IRS does not view transmission as an integral part of electricity generation. There is an element of subjectivity: onsite roads for construction access can be considered significant, but roads that allow access to the site itself or for employees or visitors alone are not.

Can Work Ever Stop After It Has Begun?

Like the 1603 guidance, work must be continuous once it begins, but the guidance provides flexibility to account for such delays as work stoppages due to presence of endangered species, inability to obtain particular equipment of limited availability, financing delays of less than six months, supply shortages, and licensing and permitting delays. See the guidance for the full list.

Must the Significant Work Conclude by a Certain Time?

There is no mandatory "placed-in-service" end date to determine eligibility. In other words, if a developer were to meet the definition of begin construction, the taxpayer would not have an end date by which the facility must be placed in service. However, a developer will have to show continuous efforts, as noted above, and as defined in the guidance.

2. Safe Harbor Provision

Like the 1603 guidance, the new IRS guidance provides developers a safe harbor to remain eligible for the PTC or ITC so long as they incur five percent of total project costs before January 1, 2014. However, this new guidance differs in a few key ways, most notably in requiring continuous construction work for those taxpayers choosing the safe harbor pathway. In addition, project cost overruns—if they reduce the amount incurred before 2014 below five percent—could later jeopardize the ability to claim the PTC or ITC.

How is the Five Percent Threshold Determined?

Costs counted toward the safe harbor provision are limited to the "depreciable basis of the facility." Safe harbor costs also explicitly exclude costs associated with the purchase of land or any property not integral to the facility. Costs can be incurred by an equipment supplier to a taxpayer if there is a proper contractual relationship between the two (or

more) entities.

What Ongoing Actions Are Required to Enjoy the Safe Harbor?

Once work has begun, it must be continuous until the project is placed in service. Under the new guidance but IRS provides significant flexibility, allowing for delays due to the presence of endangered species, the inability to obtain particular equipment of limited availability, financing delays of less than six months, supply shortages, and licensing and permitting delays. The guidance specifies that these enumerated disruptions outside the developer's control will not automatically indicate a lack of continuous effort toward completion.

How Long After Meeting the Safe Harbor Must the Facility Be Placed in Service?

There is no mandatory "placed-in-service" end date to determine eligibility. In other words, if a developer were to meet the definition of begin construction the taxpayer would not have an end date by which the facility must be placed in service. However, a developer will have to show continuous efforts, as noted above, and as defined in the guidance.

What Happens if Project Costs Later Change?

Cost overruns can jeopardize the safe harbor if the initial costs made before January 1, 2014, ultimately fall below five percent of final total costs. In that situation, if a single project cannot be separated into smaller facilities, then the PTC and ITC cannot be claimed for any portion of the project. For projects comprised of multiple facilities (such as a wind farm), the guidance provides more flexibility by allowing taxpayers to claim the PTC or ITC on a portion of the individual facilities comprising the single project. If a developer utilizes the safe harbor this way, the total aggregate cost of those individual facilities cannot exceed twenty times the amount incurred before January 1, 2014.

While this recent guidance largely follows the framework established by the 1603 Grant Program guidance, taxpayers should rely on the new IRS guidance as significant distinctions do exist. For more information, please do not hesitate to contact ML Strategies or consult the official guidance document here.

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