

# New “begun construction” rules apply for purposes of Section 45 renewable electricity production and Section 48 investment tax credits

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Prior to modifications contained in the American Taxpayer Relief Act of 2012 (ATRA), taxpayers were only eligible for the Section 45 renewable electricity production tax credit (PTC) for a qualified energy facility if it was placed in service before Jan. 1, 2014 (wind facilities were required to be placed in service before Jan. 1, 2013). With the extension of the PTC uncertain and because renewable electricity projects typically take several years to complete, many taxpayers would have found it difficult to meet the placed in service requirement by Dec. 31, 2013. Enacted in early 2013, ATRA provided welcome relief by extending the wind PTC through 2013 and replacing the placed in service requirement with a requirement that construction begin before Jan. 1, 2014.

A taxpayer can receive a PTC for every kilowatt hour of electricity produced (and sold to an unrelated party) from qualified energy resources and at a qualified facility during the first 10 years after the facility is originally placed in service. Qualified facilities and the respective credit rates are as follows:

Type of Facility	Credit Rate per Kwh	Inflation Adjusted Rate
Wind	1.5¢	2.3¢
Closed-loop biomass	1.5¢	2.3¢
Open-loop biomass	.75¢	1.1¢
Geothermal	1.5¢	2.3¢
Landfill gas	.75¢	1.1¢
Trash combustion	.75¢	1.1¢
Hydropower	.75¢	1.1¢
Marine and hydrokinetic	.75¢	1.1¢

A taxpayer may elect under Section 48(a)(5) to claim the Section 48 energy investment tax credit (ITC) with respect to a facility in lieu of the PTC. The ITC is a 30 percent credit on the eligible basis of renewable energy property placed in service.

The IRS recently released Notice 2013-29 to provide guidance with respect to when construction is deemed to begin. As expected, this guidance has many similarities to the guidance defining when construction begins for purposes of the payment in lieu of tax credit program under Section 1603 of the American Recovery and Reinvestment Act of 2009. There are, however, some important differences in Notice 2013-29 as compared to the Section 1603 guidance.

Notice 2013-29 provides two methods for determining when construction of a qualified facility begins:

1. Beginning physical work of a significant nature
2. Meeting the safe harbor requirements

### **Physical work of a significant nature**

Construction on a facility is deemed to begin when physical work of a significant nature begins. Making this determination depends on all relevant facts and circumstances, but, in general, work performed by the taxpayer or work performed for the taxpayer by other persons under a binding contract that is entered into prior to the manufacture, construction or production of the property for use by the taxpayer in the taxpayer's trade or business is taken into account.

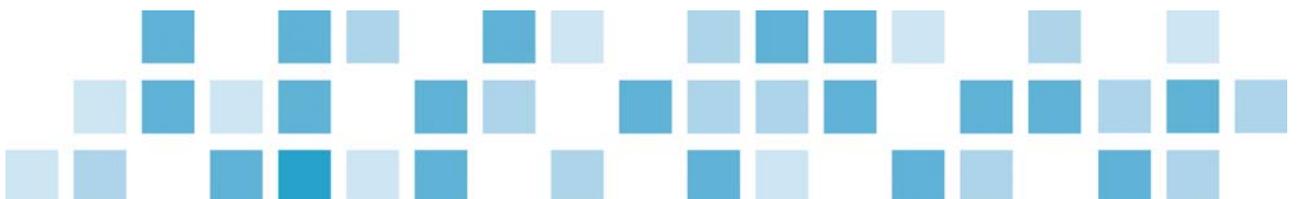
Once construction starts, there must be continuous progress in the construction. This requirement is designed to prevent taxpayers from "beginning" construction just to qualify for tax benefits, and then delaying the project for a period of time. This continuous progress requirement was not contained in the Section 1603 guidance. This is an important difference from the Section 1603 program, which required the property to be placed in service by a certain date.

### **On-site and off-site work**

Both on-site and off-site work may be considered for purposes of determining when physical work of a significant nature begins. On-site work for a wind turbine project could include excavation and pouring of concrete for the foundation. Off-site work could include the manufacture and construction of the turbines and tower components. As long as the off-site work is done pursuant to a binding, written contract and the components are not held in the manufacturer's inventory, construction will be deemed to occur when manufacture begins.

### **Preliminary activities**

Preliminary activities are excluded for purposes of determining when physical work of a significant nature begins. Preliminary activities include planning, obtaining permits



and licensing, designing, securing financing, clearing a site, testing to determine soil conditions, and excavating to change the contour of the land. Removal of existing turbines and towers is also considered preliminary work for these purposes.

### **Binding written contract**

A contract is considered binding only if it is enforceable under local law and does not limit damages to a fixed amount (e.g., through use of a liquidated damages provision). However, a five percent safe harbor provides that this rule will not apply as long as the contract limits damages to at least five percent of the total contract price. In such case, the payment of a fixed amount of damages would not be considered liquidated damages.

### **Master contract**

In some cases, a taxpayer may enter into one binding, written master contract for a specific number of components to be manufactured by another person and then through a new binding, written contract (e.g., a project contract) assign its rights to certain components to an affiliated special purpose vehicle that will own the facility for which such property is to be used. Under these circumstances, work performed under the master contract will be considered for purposes of determining when physical work of a significant nature begins on the facility.

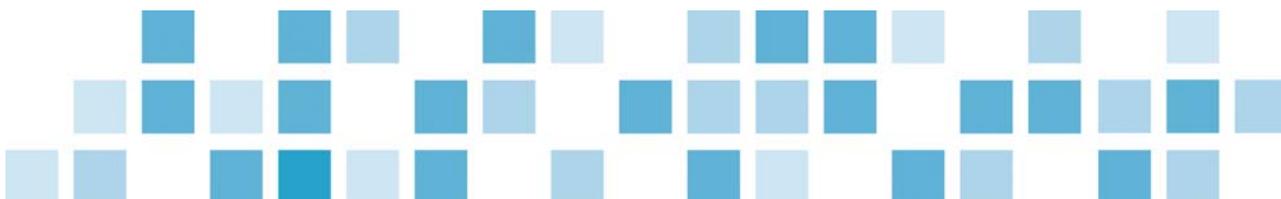
### **Facility**

A facility includes all components of property that are functionally interdependent in that the placing in service of each component is dependent upon the placing in service of each other component in order to produce electricity. For example, in a wind facility, the wind turbine, the tower and the supporting pad are all functionally interdependent, and the three together would be treated as a single facility.

### **Single project**

One renewable electricity project may consist of several separate facilities. For purposes of determining when physical work of a significant nature begins, multiple facilities that are operated as part of a single project will be treated as a single facility. Making this determination depends on the facts and circumstances. However, factors indicating that multiple facilities are operated as part of a single project include:

- The facilities are owned by a single legal entity
- The facilities are constructed on contiguous pieces of land
- The facilities are described in a common power purchase agreement
- The facilities have a common intertie



- The facilities have a common substation
- The facilities are described in one or more common environmental or other regulatory permits
- The facilities were constructed under a single master construction contract
- The construction of the facilities was financed under the same loan agreement

### Property integral to the facility

Only work that is an integral part of the activity performed by the facility is considered for purposes of determining whether construction has begun on a facility. For example, working to build an electricity transmission tower is not considered because transmission of electricity is not an integral part of the activity performed by the facility, which is the production of electricity. In contrast, work on a custom-designed transformer that steps up the voltage of electricity produced at the facility to the voltage needed for transmission is considered physical work of a significant nature because power conditioning equipment is considered to be an integral part of the activity performed by the facility.

### Roads

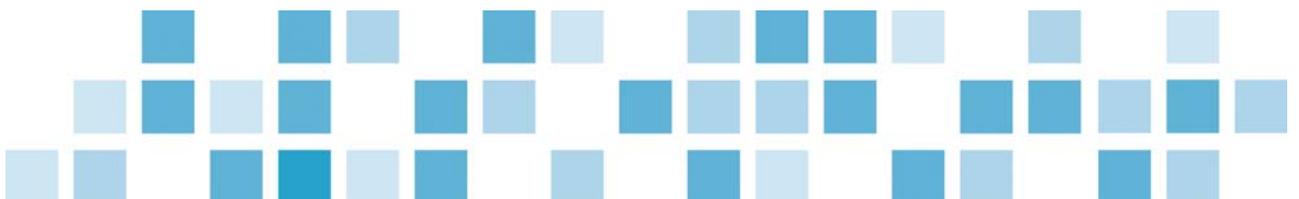
The construction of roads will qualify for purposes of determining when physical work of a significant nature begins if the roads are integral to the activity being performed by the facility. Roads that are built to enable machinery and equipment to reach the site or to enable employees and visitors to reach the site would not be considered integral to the activity of producing electricity. However, roads that are built to move materials to be processed by the facility (e.g., biomass) would qualify because they are integral to the activity being performed by the facility.

### Buildings

Generally, buildings are not considered integral to the activity being performed by the facility. However, a building that houses property that is integral to activity of the facility could qualify if the use of the structure is so closely related to the use of the housed property that the structure can clearly be expected to be replaced when the property it initially houses is replaced.

### Continuous construction

Whether a taxpayer engages in a continuous program of construction is a factual determination. Certain disruptions that are beyond the taxpayer's control will not be considered for purposes of determining whether continuous construction has occurred, including:



- Severe weather
- Natural disasters
- Licensing and permitting delays
- Delays at the request of a state or federal agency regarding matters of safety, security or similar concerns
- Labor stoppages
- Inability to obtain specialized equipment
- Presence of endangered species
- Financing delays of less than six months
- Supply shortages

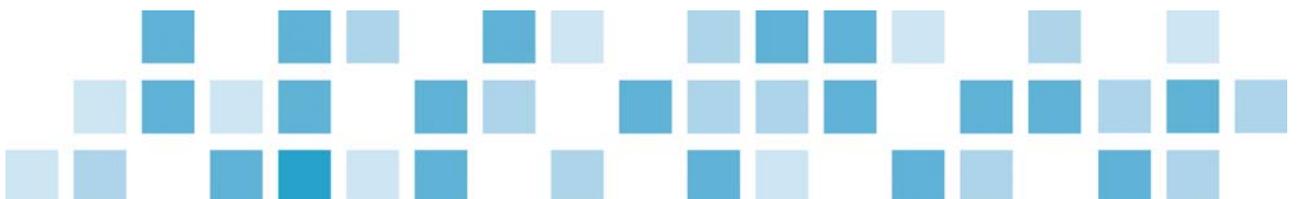
### Meeting the safe harbor requirements

Construction of a facility will be deemed to have begun before Jan. 1, 2014, if (1) the taxpayer pays or incurs five percent or more of the total cost of the facility before Jan. 1, 2014, and (2) makes continuous efforts to advance towards completion of the facility.

Understanding the concept of “paid” and “incurred” is extremely important for purposes of the safe harbor but is not addressed in Notice 2013-49 other than by reference to Section 461 and the regulations thereunder. If the taxpayer is on the cash basis of accounting, five percent of the cost of the qualified facility must be “paid” before Jan. 1, 2014. If the taxpayer is on the accrual method of accounting, then five percent of the cost of the qualified facility must be “incurred” before Jan. 1, 2014. Determining when a cost is incurred is governed by the “all events” test in Section 461(h)(4), which states that the all events test is met with respect to any item when all events have occurred which determine the fact of the liability and the amount can be determined with reasonable accuracy. A simplistic view of the all events test might consider it met when an invoice is received for materials or services.

The all events test, however, must be applied in conjunction with the “economic performance” rules in Section 461(h)(1), (2) and (3) and Reg. Section 1.461-4. A cost may be fixed and determinable, but the all events test is not deemed to be met until economic performance has occurred with respect to the item.

The general rule for services is that economic performance occurs as the services are provided.



For example, if an accrual basis taxpayer receives an invoice from a contractor on Dec. 29, 2013, for a down payment on the construction of a wind facility but work does not begin on the facility until 2014, the costs represented by that invoice cannot be included for purposes of the section 179 safe harbor.

The general rule for property is that economic performance occurs as the person provides such property to the taxpayer, i.e., when the property is delivered or accepted or when title to the property passes to the taxpayer.

There are two important exceptions to the general rules: (1) if the taxpayer is on the percentage of completion method of accounting with respect to long-term contracts, economic performance occurs at the earlier of when the service or property is provided or as the taxpayer makes payment in cash or cash equivalent to the person providing the service or property, and (2) if the taxpayer reasonably expects the services or property to be provided within 3.5 months after the date of payment, economic performance is deemed to occur when the taxpayer makes payment in cash or cash equivalent to the person providing the service or property.

### **Total cost of facility**

The total cost of the facility includes all costs properly included in the depreciable basis of the facility, but does not include the cost of any land or property that is not integral to the facility.

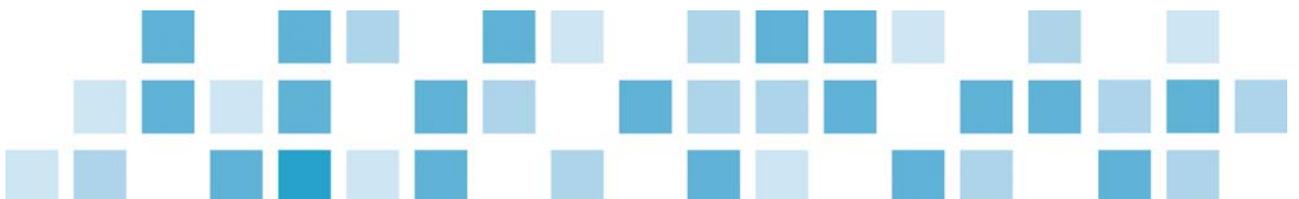
### **Look-through for economic performance**

The five percent safe harbor includes the costs associated with property that is produced for the taxpayer by a third-party contractor or other person pursuant to a written, binding contract. The taxpayer is deemed to incur the costs when the costs are incurred by the contractor pursuant to its method of accounting. For this look-through provision to apply, the contractor or other person must meet the economic performance requirements discussed above. This look-through provision does not extend to subcontractors.

### **Continuous efforts**

Whether a taxpayer makes continuous efforts to complete the facility is a factual determination. However, factors that would indicate continuous efforts include:

- Paying or incurring additional amounts included in the total cost of the facility
- Entering into binding written contracts for components or future work on construction of the facility
- Obtaining necessary permits
- Performing physical work of a significant nature



## Disruptions to continuous efforts

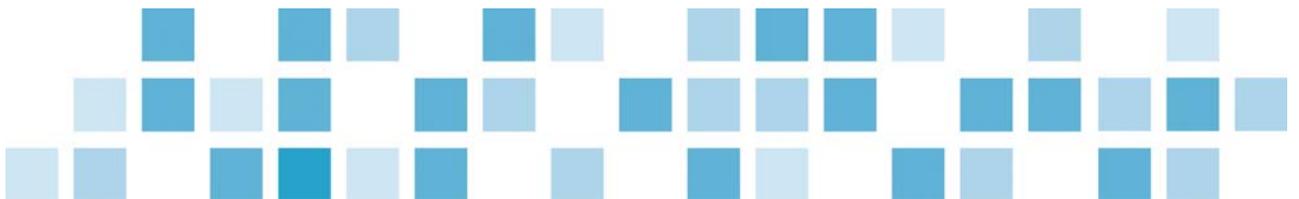
Certain disruptions beyond the control of the taxpayer will not be considered for purposes of determining whether continuous efforts have been made. The same examples contained in “continuous construction” above were cited in the notice as disruptions that would be considered beyond the control of the taxpayer.

## Cost overruns

It is possible that cost overruns could cause the total cost of a project to rise to the point that the five percent safe harbor is not satisfied before Jan. 1, 2014. In this case, the safe harbor test would not be fully satisfied. However, in the case of a single project consisting of multiple facilities, the PTC or ITC could still be claimed on some of the individual facilities as long as the total aggregate costs of those individual facilities is not more than 20 times greater than the amount the taxpayer paid or incurred before Jan. 1, 2014.

*For example:* A taxpayer incurs \$25,000 in costs in 2013 as part of a five-turbine wind farm that will be operated as a single project. The anticipated cost of each turbine is \$100,000, for a total cost of the facility of \$500,000. Since \$25,000 is equal to five percent of the total anticipated cost of the facility, it would appear that the five percent safe harbor is met. However, as construction continues, cost overruns cause the actual total cost of the facility to rise to \$600,000, with each turbine costing \$120,000. The \$25,000 paid or incurred in 2013 would now represent less than five percent of the total cost of the facility. Even though the five percent safe harbor is no longer met, the taxpayer would still be treated as satisfying the safe harbor for four of the turbines, since their actual cost of \$480,000 is less than 20 times the \$25,000 paid or incurred in 2013. The taxpayer would be able to claim the PTC on electricity produced by four of the turbines or the ITC based on the \$480,000 cost of four turbines.

*Single facility:* A taxpayer can completely lose the five percent safe harbor protection in the case of a single facility that is not part of a project consisting of multiple facilities. If the actual cost of such a facility exceeds the anticipated costs to the point that amounts paid or incurred in 2013 are less than five percent of the total cost of the facility, the taxpayer will lose the ability to apply the five percent safe harbor to any part of the facility.



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