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IRS Releases New Guidance Regarding the “Beginning of Construction” Requirement for Qualified Facilities

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On May 5, 2016, in response to a number of questions regarding the extension of renewable electricity production tax credits (“PTCs”) under Section 45 of the Internal Revenue Code of 1986, as amended (the “Code”), and Code Section 48 energy investment tax credits (“ITCs”) by the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”), the IRS issued Notice 2016-31 to clarify the beginning of construction requirements for both new and retrofitted qualified facilities. The IRS acknowledged in Notice 2016-31 that it anticipates issuing “beginning of construction” guidance for solar facilities qualifying under Code Section 48 in the near future.

The PATH Act included amendments to the PTC and the ITC for certain renewable energy facilities. The PATH Act extended the PTC for two years with respect to (i) closed-loop biomass facilities, (ii) open-loop biomass facilities, (iii) geothermal energy facilities, (iv) landfill gas facilities, (v) trash facilities, (vi) qualified hydropower facilities, and (vii) marine and hydrokinetic renewable energy facilities, the construction of which begins before January 1, 2017. It also extended the PTC for wind facilities, the construction of which begins before January 1, 2020. However, the PTC for wind facilities will phase out over the next four years by twenty percent each year. The PATH Act also extended the ITC for solar energy facilities, the construction of which begins before January 1, 2022; separate guidance should be released to address this extension.

Under Code Sections 45 and 48, as well as under Notices 2013-29 and 2013-60, the IRS provided that a taxpayer would be eligible to qualify for ITCs and PTCs if, among other things, construction on the facility began before January 1, 2014. Notice 2013-29 stated that the beginning of construction requirement could be satisfied either (i) by making a significant beginning of physical work (the “Physical Work Test”) or (ii) after the facility has been placed into service, by showing that at least five percent of the total cost of the facility had been incurred or paid before January 1, 2014 (the “Safe Harbor Test”). The relevant Code and notice provisions also required that for purposes of satisfying either the Physical Work Test or the Safe Harbor Test, the taxpayer must also have made continuous progress toward completing the project after construction began (the “Continuity Requirement”). Notice 2013-60 provided that this Continuity Requirement would be considered satisfied if the facility was placed into service before January 1, 2016 (the “Continuity Safe Harbor”). In that notice, the IRS and the Treasury Department also indicated that the transfer of a facility by an owner or developer after construction begins would not necessarily bar the facility from qualifying for



an ITC or a PTC. Notice 2014-46 clarified the manner in which both the Physical Work Test and the transfer of a facility after the beginning of construction would affect a taxpayer's eligibility for ITCs and PTCs. That notice also lowered the Safe Harbor Test from five percent to three percent in certain circumstances. After an extension of the PTC and the ITC by the Tax Increase Prevention Act of 2014, the IRS and the Treasury Department issued Notice 2015-25 which extended the Continuity Safe Harbor if a taxpayer began construction on a facility prior to January 1, 2015, and placed the facility in service before January 1, 2017, regardless of the amount of physical work performed or the amount of costs paid or incurred with respect to the facility after December 31, 2014 and before January 1, 2017.

With respect to the Continuity Safe Harbor, Notice 2016-31 further extends and modifies it and provides additional guidance regarding its application in the context of qualified facilities which take the PTCs under Code Section 45 or elect to take the ITCs under Code Section 48. In addition, this notice provides guidance regarding the Physical Work Test and clarifies the application of the Safe Harbor Test to retrofitted qualified facilities.

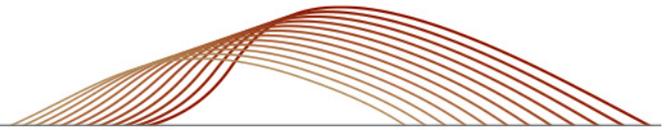
Extension, Modification, and Clarification of the Continuity Safe Harbor

In response to the extension of the PTC by the PATH Act, Notice 2016-31 extends the Continuity Safe Harbor provided in Notice 2013-60 so that a facility will be considered to satisfy the Continuity Safe Harbor if a taxpayer places a facility in service during a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began. The notice also provides that a taxpayer may not combine methods so that one cannot rely upon the Physical Work Test and the Safe Harbor Test in alternating calendar years to satisfy the beginning of construction requirement or the Continuity Requirement. The notice also revises the non-exclusive list of excusable construction disruptions first provided in Notice 2013-29 by adding:

- Delays in obtaining permits or licenses from federal, state, local, or Indian tribal governments, including, but not limited to, delays in obtaining permits or licenses from the Federal Energy Regulatory Commission, the Environmental Protection Agency, the Bureau of Land Management, and the Federal Aviation Agency;
- Delays at the written request of a federal, state, local, or Indian tribal government regarding matters of public safety, security, or similar concerns;
- Interconnection-related delays, such as those relating to the completion of construction on a new transmission line or necessary transmission upgrades to resolve grid congestion issues that may be associated with a project's planned interconnection;
- Delays in the manufacture of custom components; and
- Financing delays (of any time period, instead of those less than six months).

Guidance Regarding Application of the Physical Work Test

As provided in Notice 2014-46, the Physical Work Test focuses on the nature of the work performed, instead of the amount or the cost, so that there is no fixed minimum amount of work, or monetary or percentage threshold required, to satisfy the test. In order to satisfy the Physical Work Test, the physical work must be of a significant nature, which does not include preliminary activities, as provided in Notice 2013-29. Notice 2016-31 clarifies the list of preliminary activities by including (i) conducting geologic mapping and modeling, (ii) conducting geophysical, gravity, magnetic, seismic,



and resistivity surveys, (iii) conducting environmental and engineering studies, and (iv) performing activities to develop a geothermal deposit prior to valid discovery.

Under Notice 2013-29, multiple facilities that are operated as part of a single project will be treated as a single facility for purposes of determining whether construction of a facility has begun for purposes of Sections 45 and 48. Notice 2016-31 provides that this single project rule may be applied to facilities that rely upon either the Physical Work Test or the Safe Harbor Test to satisfy the Continuity Requirement and that determination of whether multiple facilities are operated as part of a single project must be determined in the calendar year during which the last of the multiple facilities is placed in service. Multiple facilities that are operated as part of a single project may be disaggregated and treated as separate facilities for purposes of determining whether a facility satisfies the Continuity Safe Harbor. If a disaggregated facility is placed in service prior to the Continuity Safe Harbor deadline, it will be eligible for the Continuity Safe Harbor, and if not, it may still satisfy the Continuity Requirement under a facts and circumstances determination. The notice provides that this disaggregation rule may be applied to facilities that rely upon either the Physical Work Test or the Safe Harbor Test to satisfy the Continuity Requirement.

Application of the Safe Harbor Test to Retrofitted Facilities

Under Rev. Rul. 94-31 and Notice 2008-60, a facility may qualify as originally placed in service even though it contains used property; however, the fair market value of the used property cannot be more than twenty percent of the facility's total value (the "80/20 Rule"). If a single project is comprised of multiple facilities, the 80/20 Rule is applied to each individual facility within the single project. If new property is used to retrofit an existing facility, Notice 2016-31 provides that the Safe Harbor Test is only applied with respect to the cost of the new property for purposes of satisfying the beginning of construction for Sections 45 and 48.

Conclusion

By issuing Notice 2016-31, the IRS has sought to clarify the beginning of construction requirements by extending the Continuity Safe Harbor and providing additional guidance on the Physical Work Test and the application of the Safe Harbor Test to retrofitted qualified facilities. Please call our energy tax credit expert, Michael Haun, if you would like to discuss further.



If you have any questions concerning these developing issues, please do not hesitate to contact the following Atlanta Paul Hastings lawyer:

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