IRS Provides Relief for Renewable Energy Developers Encountering Construction Delays

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The Internal Revenue Service (IRS) recently released Notice 2020-41 (the Notice), providing important relief with respect to the beginning-of-construction requirement for the production tax credit (PTC) and the investment tax credit (ITC) for certain renewable energy facilities that have encountered construction delays as a result of the COVID-19 pandemic. As described in further detail below, the Notice provides an additional year to satisfy the "Continuity Safe Harbor" for projects that began construction in either calendar year 2016 or 2017. In addition, the Notice provides that a taxpayer will be deemed to satisfy the "3½ Month Rule" where the taxpayer paid for services or property on or after September 16, 2019, and actually receives such services or property by October 15, 2020.

Background

In general, a taxpayer can claim PTCs under Section 45 of the Internal Revenue Code (the Code) with respect to electricity produced at a "qualified facility" (generally a wind, closed-loop biomass, open-loop biomass, geothermal, landfill gas, trash, hydropower, or marine and hydrokinetic facility). Alternatively, a taxpayer may elect to claim an ITC under Section 48 of the Code with respect to a qualified facility or for a solar energy facility, in either case in an amount calculated by reference to the taxpayer's basis in the facility.

Among other requirements, the amount of the PTCs or ITC available with respect to a facility is dependent upon when construction of such facility begins. The amount of PTCs available to a wind facility is reduced if construction begins after December 31, 2016, and the ITC available to a solar energy facility is reduced if construction begins after December 31, 2019. It is thus vital for renewable energy developers and investors to be able to determine with certainty when construction of a facility began.

The IRS has provided two ways to establish the beginning of construction: (i) the "Physical Work Test," and (ii) the "Five Percent Safe Harbor." Under the Physical Work Test, construction of a facility begins when "physical work of a significant nature begins." Whether the Physical Work Test is satisfied requires a close analysis of the relevant facts and circumstances. Under the Five Percent Safe Harbor, construction of a facility begins with respect to an accrual basis taxpayer when the taxpayer "incurs" 5% or more of the total cost of the facility. When a cost is incurred is generally determined under the principles of Section 461 of the Code. Under these principles, a cost is generally incurred when the relevant services or goods are delivered. However, under a special rule, a cost is deemed incurred when the taxpayer makes a required payment to

the person providing the services or property if the taxpayer can "reasonably expect" the person to provide the services or property within 3½ months after the date of payment (3½ Month Rule).

Both the Physical Work Test and Five Percent Safe Harbor require a taxpayer to make continuous progress toward completion of the facility once construction has begun (Continuity Requirement). The IRS has provided a "Continuity Safe Harbor," whereby a facility is deemed to satisfy the Continuity Requirement. Prior to the Notice, the Continuity Safe Harbor provided that if a taxpayer places a facility in service by the end of a calendar year that is no more than four calendar years after the calendar year in which construction of the facility began, the facility will be considered to satisfy the Continuity Safe Harbor and thus the Continuity Requirement.[1]

Effect of COVID-19 Pandemic

The effect of the COVID-19 pandemic on global supply chains, construction operations and governmental permitting capabilities has raised significant concerns among renewable energy developers and investors. Specifically, there have been concerns that construction delays could cause a project to fail to satisfy the Continuity Requirement, or that a delay in delivery of components may cause the cost of such components to not satisfy the 3½ Month Rule and thus not be taken into account in a given year for purposes of the Five Percent Safe Harbor. Although the Continuity Requirement can be satisfied based on an examination of the particular facts and circumstances, developers and investors generally prefer the certainty of the Continuity Safe Harbor. Additionally, although the 3½ Month Rule is based on the payor's reasonable expectations at the time of payment, developers and investors generally prefer to receive the services or goods within 3½ months of the date of payment in order to confidently claim the relevant costs have been incurred for purposes of the Five Percent Safe Harbor.

COVID-19 disruptions have been of particular concern to developers and investors in wind facilities that began construction in 2016 (the last year of eligibility for 100% of the PTCs) and solar facilities that began construction in 2019 (the last year of eligibility for 100% of the ITC).

Extension of the Continuity Safe Harbor

The Notice provides that for a facility that began construction under the Physical Work Test or the Five Percent Safe Harbor in either calendar year 2016 or 2017, the Continuity Safe Harbor is satisfied if a taxpayer places the facility in service by the end of a calendar year that is no more than five calendar years after the calendar year during which construction of that facility began.

Taxpayers that began construction of a facility under either the Physical Work Test or the Five Percent Safe Harbor in calendar year 2016 or 2017 now have until calendar year 2021 or 2022 (rather than 2020 or 2021), respectively, to place such facility in service and satisfy the Continuity Safe Harbor. This should be particularly helpful for wind facilities that, prior to the Notice, needed to be placed in service in 2020 to satisfy the Continuity Safe Harbor and thus qualify for the full PTC. Such facilities now have until December 31, 2021, to be placed in service.

Safe Harbor for 3½ Month Rule

As discussed above, whether the 3½ Month Rule applies is generally determined by whether the taxpayer reasonably expected delivery within 3½ months of the date of payment. However, proving a taxpayer's reasonable expectation at the time of payment may be difficult (particularly if they fail to receive such services or goods within the requisite time frame), and taxpayers generally are more comfortable if they actually receive the relevant services or goods within 3½ months of the date of payment that such costs were incurred under the 3½ Month Rule.

The Notice provides that for services or property paid for by a taxpayer on or after September 16, 2019, the taxpayer will be deemed to have had a reasonable expectation that the services or property would be received within 3½ months after the date of payment in the case of any services or property actually received by a taxpayer by October 15, 2020 (3½ Month Safe Harbor). Accordingly, if a developer paid for facility components on or after September 16, 2019, and receives such components by October 15, 2020, the cost of such components will be deemed to be incurred in 2019 for purposes of the Five Percent Safe Harbor.

The Notice should be particularly helpful for solar facility developers that paid for components toward the end of 2019, with the expectation that such goods would be received within 3½ months of the date of payment and thus such costs would qualify for the Five Percent Safe Harbor in 2019.

It is important to note, however, that the 3½ Month Rule is based on a taxpayer's reasonable expectations at the time of payment. Accordingly, even if the 3½ Month Safe Harbor does not apply to a particular cost (*e.g.*, delivery is delayed beyond October 15, 2020), a taxpayer may still prove that such costs were properly incurred at the time of payment.

[1] Under Notice 2019-43, the Continuity Safe Harbor may be tolled and extended in certain limited circumstances involving significant national security concerns.