

September 23, 2013

*Practice Groups:*  
*Energy, Tax*

## IRS Notice 2013-60 Clarifies Rules on Beginning of Construction

*By Dirk Michels, Charles H. Purcell, Michael W. Evans, Won-Han Cheng, Elizabeth C. Crouse*

On September 20, 2013, the U.S. Department of the Treasury (“Treasury”) released Notice 2013-60,<sup>1</sup> which clarifies in important ways the eligibility rules applicable to the investment tax credit (“ITC”) and production tax credit (“PTC”) for certain alternative energy facilities. Notice 2013-60 is the second notice released by Treasury to provide additional guidance on the new “begin construction” requirement adopted in 2013 by Congress in the American Taxpayer Relief Act of 2012 (the “ATRA”). The ATRA amended the ITC and PTC provisions for certain alternative energy facilities by providing that the PTC and ITC are available to such facilities if construction of the facilities begins before January 1, 2014. Under prior law, alternative energy facilities had to be “placed in service” before the expiration date in order to qualify for the credits.

The Treasury first released guidance on the new “begin construction” requirement April 15, 2013 in Notice 2013-29, but left a number of questions open. Notice 2013-60 resolves certain of these issues, generally in a taxpayer favorable manner. The new guidance presents significant opportunities for those interested in investing in alternative energy projects, but each project should be carefully analyzed to determine whether it qualifies under the guidance.

The new guidance (i) provides that if construction begins on a facility this year and the facility is placed in service prior to the end of 2015, the facility will be deemed to have satisfied the “continuous construction” requirement applicable to these facilities, (ii) makes clear that if a taxpayer assigns a “master contract” to construct equipment used in an eligible facility to an affiliated entity, work performed under the contract will be taken into account for both the “physical work” test and the “5% safe harbor”, and (iii) specifically states that a transfer of a facility that meets the “begin construction” requirement to a third party (even an unrelated party) will not prevent the third party from claiming the ITC or PTC.

### Detailed discussion

The “begin construction” requirement of the ATRA applies to wind, closed- and open-loop biomass, geothermal, landfill gas, trash, hydropower, and marine and hydrokinetic facilities. The extensions could provide substantial benefits to taxpayers who begin construction on these facilities prior to the end of 2013.

In Notice 2013-29, Treasury issued guidance<sup>2</sup> to assist taxpayers in determining whether construction has begun on a facility. The guidance is very similar to the guidance issued in the context of Treasury’s 1603 grant program for alternative energy projects and presents similar planning opportunities for tax equity investors and developers. This guidance was further refined in Notice 2013-60.

<sup>1</sup> Notice 2013-60, 2013-20 IRB 1085

<sup>2</sup> Notice 2013-29, 2013-20 IRB.

## IRS Notice 2013-60 Clarifies Rules on Beginning of Construction

### Notice 2013-29

Under Notice 2013-29, the taxpayer may “begin construction” by showing that before January 1, 2014 the taxpayer or its contractor has either (1) undertaken physical work of a significant nature (the “Physical Work” test) or (2) paid or incurred at least five percent of the total cost of the facility (the “5% safe harbor”).

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

Under Notice 2013-29, construction is deemed to begin when physical work to construct a facility begins, provided that the physical work is of a “significant nature.” In order to be significant, the work must not be preliminary<sup>3</sup> and must be on tangible property<sup>4</sup> that is used as an integral part of the facility’s energy production activities. Any amount of work undertaken on integral parts of the facility before January 1, 2014 will qualify, but the work must occur in the context of a continuous program of construction.<sup>5</sup> Work to produce property that would normally be held in inventory does not qualify.

For purposes of determining whether a taxpayer has satisfied the Physical Work test, Treasury will disregard certain interruptions of construction, including those resulting from: severe natural events; licensing, permitting, or other regulatory delays; labor stoppages; equipment or supply shortages; certain financing delays; and the presence of endangered species. Under Notice 2013-29, this test was based on facts and circumstances. (As discussed more fully below, Notice 2013-60 provides that if construction begins on a facility this year and the facility is placed in service prior to the end of 2015, the facility will be deemed to have satisfied the “continuous construction” requirement.)

To qualify under the Physical Work test, the work may be performed either by the taxpayer or by the taxpayer’s contractor if the two parties enter into a “binding” written contract prior to the beginning of construction. For this purpose, a written contract is binding if it is enforceable under local law against the taxpayer and does not limit damages to a specific amount. In addition, the contractor’s work must be of a “significant nature” and must be undertaken specifically for the taxpayer in question. If a taxpayer enters into a binding written contract for a specific number of components to be manufactured or constructed for the taxpayer under a binding written contract (a “master contract”), and then the taxpayer assigns its rights to certain components to an affiliated special purpose vehicle that will own the facility for which such property is to be used, work performed with respect to the master contract may be taken into account in determining when physical work of a significant nature begins with respect to the facility.

<sup>3</sup> Preliminary work includes planning or designing, securing financing, exploring, researching, obtaining permits, licensing, conducting surveys, environmental and engineering studies, clearing a site, test drilling of a geothermal deposit, test drilling to determine soil condition, and excavation to change the contour of the land (as opposed to excavation for footings and foundations).

<sup>4</sup> For this purpose, tangible property typically includes equipment, whether movable or affixed to a building or the ground, and other items of personal and some real property. It does not include intangible property such as design plans, customer relationships, and contracts. In addition, the property must be either used to generate (and not merely transmit) electricity, certain onsite roadways, or a building that is either essentially an item of equipment or so closely related to the use of certain property that it is reasonable to expect that the building would be replaced at the same time as that property.

<sup>5</sup> Recent comments by a U.S. Treasury representative indicate that pursuing a power purchase agreement may constitute a continuous program of construction.

## IRS Notice 2013-60 Clarifies Rules on Beginning of Construction

### *Five percent of cost incurred*

Under the 5% safe harbor, Treasury will deem the construction of a project to have begun before January 1, 2014 if the taxpayer (1) pays or incurs at least five percent of the total cost of the facility<sup>6</sup> before January 1, 2014 *and* (2) thereafter makes continuous efforts to complete the facility.<sup>7</sup> If the total cost of a project comprised of multiple facilities exceeds expectations so that less than five percent of the total project cost was spent before January 1, 2014, then the taxpayer may not be able to claim the ITC or PTC.

Costs paid or incurred by a contractor to perform work for the taxpayer under a written binding contract are considered to be paid or incurred by the taxpayer. In addition, the costs paid or incurred by the contractor must be used to produce property that would not normally be included in inventory and that would contribute to the total cost of the facility.

### **Notice 2013-60**

Following the release of Notice 2013-29 and in response to a number of questions received by Treasury and the Internal Revenue Service (“IRS”), Treasury issued Notice 2013-60.

### *Continuous construction*

As noted above under both the Physical Work test and the 5% safe harbor, there must be continuous construction (or efforts) on a project in order for the project to qualify under the “begin construction” provision. Notice 2013-60 (i) provides that if construction begins on a facility this year and the facility is placed in service prior to the end of 2015, the facility will be deemed to have satisfied the “continuous construction” requirement applicable to these facilities under either test. If a facility is not placed in service before January 1, 2016, whether the facility satisfies the continuous construction requirement will be determined by the relevant facts and circumstances. This provision of Notice 2013-60 provide certainty and comfort to taxpayers developing these projects.

### *Master contracts and the 5% safe harbor*

Notice 2013-60 makes clear that if a taxpayer assigns a “master contract” to construct equipment used in an eligible facility to an affiliated entity, work performed under the contract will be taken into account for both the Physical Work test and the 5% safe harbor. Under Notice 2013-29, it was not clear that this rule applied in the case of the 5% safe harbor.

---

<sup>6</sup> For this purpose, the total cost of the facility includes only those costs attributable to the integral parts of the facility and that are included in the taxpayer’s depreciable basis in the facility. The cost of land, non-depreciable land improvements, most buildings, fences, and similar non-integral components are not included. However, certain preparatory costs that would be included in the depreciable basis of the facility, e.g., certain engineering studies, design costs, etc., may be included.

<sup>7</sup> Continuous efforts include activities such as obtaining necessary permits, performing work of a substantial nature, paying or incurring additional costs, and entering into binding written contracts for components of or future work on the facility. As with the physical work test, certain disruptions of continuous efforts to construct the facility will be disregarded.

## IRS Notice 2013-60 Clarifies Rules on Beginning of Construction

### *Transfers of facilities after the end of 2013*

Notice 2013-60 specifically states that a transfer of a facility that meets the “begin construction” requirement to a third party (even an unrelated party) will not prevent the third party from claiming the ITC or PTC if the facility otherwise meets all the requirements to claim the credit. Thus, if a developer begins construction on an alternative energy facility this year, and then transfers the project to a third party next year, the third party will be able to claim the PTC with respect to power generated by the facility or the ITC with respect to the facility, assuming the other requirements of the credit are met. While this conclusion is consistent with the ATRA, the language of Notice 2013-29 raised some concerns. This statement should make it clear that a third party transferee will be able to claim the credit and allay concerns of investors on this point.

Treasury will be looking to help businesses navigate these requirements quickly before the PTC and ITC extensions granted under ATRA expire. Although Congress has repeatedly extended the credits in years past, the ongoing debate over comprehensive tax reform means that Congress is unlikely to extend them again prior to the end of 2013. As a result, the PTC and ITC are likely to expire as scheduled at the beginning of 2014. It is possible that Congress will extend the credits retroactively later in 2014, but that prospect is very uncertain at best. Thus, the guidance for determining whether a project begins construction by the end of 2013 is particularly important.

---

#### Authors:

##### **Dirk Michels**

dirk.michels@klgates.com  
+1. 310.552.5090

##### **Charles H. Purcell**

charles.purcell @klgates.com  
+1. 206.370.8369

##### **Michael W. Evans**

michael.evans @klgates.com  
+1. 202.661.3807

##### **Won-Han Cheng**

won-han.cheng @klgates.com  
+1. 206.370.8331

##### **Elizabeth C. Crouse**

elizabeth.crouse @klgates.com  
+1. 206.370.6793

## K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt  
Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Moscow Newark New York Orange County Palo Alto Paris  
Perth Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco São Paulo Seattle Seoul Shanghai Singapore Spokane  
Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

## IRS Notice 2013-60 Clarifies Rules on Beginning of Construction

K&L Gates practices out of 48 fully integrated offices located in the United States, Asia, Australia, Europe, the Middle East and South America and represents leading global corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit [www.klgates.com](http://www.klgates.com).

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2013 K&L Gates LLP. All Rights Reserved.