KIRKLAND & ELLIS

Blog Post

IRS Updates Start of Construction Rules for Renewables Projects to Address COVID-19

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The IRS released new guidance on May 27, 2020, that extends the deadline by which 2016 and 2017 vintage renewable energy projects must be placed in service to maintain tax credit eligibility (and thus financeability by tax equity and debt providers), and adds a new safe harbor to help renewable energy developers prove to financiers that the construction of their projects started on time.

Background of Targeted Issues

Under U.S. federal income tax law, the value of production tax credits ("**PTCs**") or investment tax credits ("**ITCs**") for which a renewables project can qualify varies depending on the year in which the construction of the project begins. (See our previous post for an overview of the deadlines applicable to wind and solar). There are two ways to start construction in a given year: by starting physical work of a significant nature in that year, or by paying or incurring (according to the taxpayer's method of accounting) five percent or more of the total cost of the project in that year. Both methods are subject to a complicated web of exceptions and qualifications that have evolved over time in eight previous sets of IRS guidance.

The new guidance touches on two specific aspects of these rules.

Five Percent Test

The first clarification relates to the five percent test described above. Most business entities use the accrual method of accounting. This means that for purposes of the five percent test, they generally incur costs for capital expenditures when property is delivered or accepted, or when title passes. To give an example, if an accrual method taxpayer makes a payment for property on December 31, 2019, but the property is not delivered until February 15, 2020, then the costs are not treated as incurred until February 15, 2020. Many renewable energy developers rely on an exception to this general rule (called the "**3 ½ Month Rule**"), which says that costs can be treated as incurred on the payment date as long as the taxpayer can reasonably expect the property to be provided within 3 ½ months of payment. In the example above, the taxpayer can treat the entire December 31, 2019, payment as incurred in 2019 under the 3 ½ Month Rule as long as it reasonably expected the property to be provided within 3 ½ months.

Some financiers have been requiring sponsors relying on the 3 ½ Month Rule to represent that the equipment would actually be delivered within 3 ½ months of the payment date. To the extent COVID-19 delayed delivery expectations, this could result in a technical breach of a warranty or covenant, even though the tax rules only require the "reasonable expectation" of timely delivery.

Continuity Safe Harbor

The second rule addressed in the new guidance is the "continuity requirement," which says that once construction begins, a project either needs to be "placed in service" in the next four years (the "**Continuity Safe Harbor**") or the sponsor has to prove that work was "continuous" based on facts and circumstances. Due to the difficulty of proving continuity through subjective facts (particularly in the context of a project that has taken longer than four years to complete), a project's ability to meet the four-year continuity safe harbor deadline is a critical financeability issue for purposes of securing tax equity and debt.

As we discussed in a previous post, wind projects, which had to begin construction by the end of 2016 to avoid a haircut on tax credit value, effectively faced a December 31, 2020, placement in service deadline under the Continuity Safe Harbor to ensure tax credit eligibility.

What Changed?

The most acute issue that the guidance addresses is the Continuity Safe Harbor.

The new guidance recognizes the reality that projects effectively need to comply with the Continuity Safe Harbor in order to move forward with tax equity and debt financings and extends the Continuity Safe Harbor for an extra year — from four years to five years — for projects that began construction in 2016 or 2017. Although this will likely be of limited benefit to solar projects (which only had to begin construction by the end of 2019 before losing any credit value), the extension provides significant relief for wind developers concerned about financing commitments that could be jeopardized by COVID-19 delays.

The new guidance also acknowledges the difficulty some sponsors are having getting financiers on board with delivery timing in light of COVID-19. As discussed above, the 3 ½ Month Rule only requires the *reasonable expectation* of delivery within 3 ½ months of the payment date, but some financiers still want to see actual delivery.

The new IRS guidance fixes this glitch by establishing a new safe harbor.

The new safe harbor says that for purposes of the 3 ½ Month Rule, the taxpayer will be deemed to have had a reasonable expectation that the property would be received within 3 ½ months as long as it is actually received by October 15, 2020. Though seemingly inconsistent with a technical reading of the 3 ½ Month Rule, the guidance suggests that property received after October 15, 2020, may still qualify based on reasonable expectations regarding delivery timing at the time of payment.

Looking Ahead

The new guidance is inarguably helpful to solar developers facing real-world financeability issues with their projects.

The Continuity Safe Harbor is a particularly serious issue for wind developers facing hard placement in services deadlines, and anything short of an extension of the Continuity Safe Harbor would have been unlikely to assuage financeability concerns. This should give wind developers and financiers alike more comfort in moving forward than they had prior to publication of the IRS notice.

The new 3 ½ Month Rule safe harbor is also helpful to developers who are trying to get financiers over the line. Although a “reasonable expectation” argument should theoretically be sufficient, the security of a special safe harbor can only help projects maintain financeability.

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