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Hearing on Wind-Energy Production Tax Credit

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Introduction

Good afternoon, Chairman Lankford, Ranking Member Speier, and members of the Subcommittee.

I appreciate the opportunity to be here today to discuss the production tax credit and the investment tax credit as well as the Treasury Department's and the Internal Revenue Service (IRS) Office of Chief Counsel's release of Notice 2013-29 and Notice 2013-60. I am the Associate Chief Counsel of Passthroughs and Special Industries (PSI). With the assistance of the Office of Tax Policy at the Treasury Department, attorneys in PSI drafted Notice 2013-29 and Notice 2013-60. We then submitted the drafts of these Notices through the usual clearance processes within the Office of Chief Counsel, the IRS, and the Department of Treasury.

Energy Credits in General

Before discussing the Notices, I will first review the credits applicable to renewable energy. Several renewable energy technologies qualify for two income tax credits in the Internal Revenue Code (the Code): (1) the production tax credit (PTC) under section 45 of the Code and (2) the investment tax credit (ITC) under section 48 of the Code.

PTC: The PTC is allowed for the production of electricity from qualified energy resources at qualified facilities. Section 45(d) defines qualified facilities to include, among others, wind facilities, closed-loop biomass facilities, open-loop biomass facilities, geothermal facilities, landfill gas facilities, trash facilities, hydropower facilities, and marine and hydrokinetic facilities. To qualify for the PTC, the taxpayer must sell electricity produced from qualified energy resources at qualified facilities to an unrelated person. The PTC is based on electricity produced during the first 10 years of operation of a qualifying renewable energy facility.

ITC: For qualifying facilities, a taxpayer may make an irrevocable election to claim the ITC in lieu of the PTC. The Code allows this election only for facilities that otherwise meet the requirements for the PTC and for which no credit under section 45 has been allowed. A taxpayer that properly makes the election may claim the ITC based on a percentage of the taxpayer's eligible basis, i.e., the basis of the depreciable (or amortizable) property that is an integral part of a facility capable of generating electricity eligible for the PTC.

Section 1603 Program: As established by the American Recovery and Reinvestment Act of 2009, Pub. L. 111-5 ("ARRA") (and extended by Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111-312)), the Treasury Department, through the Office of the Fiscal Assistant Secretary, administers a Program (the "Section 1603 Program") whereby eligible persons who place in service specified energy property may request a cash payment in lieu of either the PTC or the ITC. To qualify for the Section 1603 Program, the statute requires an applicant to (1) place the energy property in service in 2009, 2010, or 2011 or (2) place the energy property in service after 2011 if construction began on the property during 2009, 2010, or 2011. If the applicant began construction during 2009, 2010 or 2011 but did not place the energy property into service until after 2011, the applicant has to place the energy property in service by the credit termination date, as defined in the statute. The credit termination date ranges, depending on the specified energy property, from January 1, 2013 to January 1, 2017. The Treasury Department issued guidance on the Section 1603 Program in various formats, including FAQs regarding the term "beginning of construction." While the Section 1603 Program is no longer available for new projects, the Treasury Department continues to make payments as applicants place qualifying projects in service before the applicable credit termination date.

American Taxpayer Relief Act of 2012

Prior to the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (ATRA), taxpayers had to place qualifying facilities in service by the end of 2012 for qualified wind facilities, and by the end of 2013 for other eligible technologies. When it enacted ATRA, Congress extended the PTC and the ITC (but not the Section 1603 Program) for wind projects for one year, through 2013. For both the PTC and the ITC, Congress changed the placed in service expiration date with a "beginning of construction" expiration date. Now, qualified facilities (as described in section 45(d) of the Code) will be eligible for the PTC or the ITC (in lieu of the PTC), if construction of such facilities begins before January 1, 2014.

According to the Joint Committee on Taxation, Congress made changes to the PTC and ITC because it believed that "additional renewable energy infrastructure will be built if the tax incentives for renewable energy are extended" and "that certain renewable power projects do not move forward because developers and investors are concerned that those projects cannot be completed before the renewable electricity production credit expires." Congress intended to reduce this uncertainty by replacing the placed-in-service expiration date with an expiration date based on when construction begins on a particular project.

Notice 2013-29

Following the statutory change to "beginning of construction" for both the PTC and the ITC, the Treasury Department and PSI issued Notice 2013-29 (released on April 15, 2013, and published in the Internal Revenue Bulletin on May 13, 2013) to provide guidance to taxpayers in determining when construction has begun. In the process of developing this guidance, we met and corresponded with taxpayers and tax practitioners representing the various energy industries eligible for the PTC or the ITC, and we received several letters from members of Congress urging prompt guidance. Many of these contacts suggested that we look to existing guidance under the Section 1603 Program on the question of when construction begins.

Treasury and the IRS believe that the use of similar phrases regarding beginning of construction and other qualifications in both the Section 1603 Program and ATRA suggests that Congress intended that we interpret those phrases in a similar manner. While the Joint Committee on Taxation did not mention the Section 1603 Program (which had a beginning of construction requirement) when it described the changes made by ATRA, Congress was aware of the Treasury Department's interpretation of beginning of construction for purposes of the Section 1603 Program when it considered the changes made by ATRA. For this reason, we looked at and drew from the guidance for the Section 1603 Program in interpreting when construction begins under the changes made by ATRA.

Under the Section 1603 Program guidance, a taxpayer could establish that construction began on a project in 2009, 2010, or 2011 by two methods: (1) begin physical work of a significant nature or (2) meet a 5% safe harbor based on costs. The Section 1603 Program provided that the Treasury Department will closely scrutinize any construction activity that does not involve (1) a continuous program of construction or (2) a contractual obligation to undertake and complete construction within a reasonable time.

Similar to the Section 1603 Program guidance, Notice 2013-29 provides two methods that a taxpayer may use to establish that construction of a qualified facility has begun. A taxpayer may establish the beginning of construction by starting physical work of a significant nature. Alternatively, a taxpayer may establish the beginning of construction by meeting a 5 percent safe harbor.

<u>Physical Work of a Significant Nature and Continuous Construction:</u> Construction of a qualified facility begins when physical work of a significant nature begins. The determination of whether a taxpayer has begun construction of a facility before January 1, 2014, will depend on the relevant facts and circumstances.

Work performed by the taxpayer counts for this test, and a taxpayer may also take into account certain work performed for the taxpayer by other persons under a binding written contract. This includes both on-site and off-site work. Notice 2013-29 gives a detailed example of the operation of these rules in a case involving on-site work at a wind facility.

The Section 1603 Program guidance provided that the Treasury Department would closely scrutinize a situation where the taxpayer fails to maintain a continuous program of construction. Similarly, Notice 2013-29 provides that the IRS will closely scrutinize a facility, and may determine that construction has not begun on a facility before January 1, 2014, if a taxpayer does not maintain a continuous program of construction, which involves continuing physical work of a significant nature. Relevant facts and circumstances will determine whether a taxpayer maintains a continuous program of construction (the "continuous construction" test). Certain disruptions in the taxpayer's construction of a facility that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to maintain a continuous construction program. Notice 2013-29 provides a non-exclusive list of examples of such disruptions: (a) severe weather conditions; (b) natural disasters; (c) licensing and permitting delays; (d) delays at the written request of a state or federal agency regarding matters of safety, security, or similar concerns; (e) labor stoppages; (f) inability to obtain specialized equipment of limited availability; (g) the presence of endangered species; (h) financing delays of less than six months; and (i) supply shortages. Like much of Notice 2013-29, the continuous construction test was adapted, with some modifications, from the Section 1603 Program guidance.

In further defining physical work of a significant nature, Notice 2013-29 excludes preliminary activities (even if the taxpayer may include the cost of those preliminary activities in the depreciable basis of the facility). Preliminary activities include such activities as 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, or test drilling to determine soil condition. Removal of existing turbines and towers is preliminary work and, therefore, does not constitute physical work of a significant nature with respect to the facility.

In addition, physical work of a significant nature does not include work (performed either by the taxpayer or by another person under a binding written contract) to produce property that is either in existing inventory or is normally held in inventory by a vendor.

Solely for purposes of determining whether construction has begun, multiple facilities that are operated as part of a single project (which depends on the relevant facts and circumstances) will be treated as a single facility. Notice 2013-29 provides an example where a wind farm will consist of 50 turbines, and in 2013, a taxpayer excavates the site for 10 of 50 foundations of the wind turbines and pours concrete for the supporting pads. Based on the facts detailed in the example, for purposes of sections 45 and 48, the example treats the entire wind farm as a single project that the taxpayer may treat as a single facility, and the example concludes that the taxpayer has performed physical work of a significant nature that constitutes the beginning of construction of that facility in 2013.

Notice 2013-29 also provides that only physical work of a significant nature on tangible personal property and other tangible property used as an integral part of the activity performed by the facility will be considered for purposes of determining whether a taxpayer has begun construction of a facility. This includes property integral to the production of electricity, but does not include property used for electrical transmission. Therefore, physical work on a transmission tower located at the site is not physical work of a significant nature because the transmission is not an integral part of the activity performed by the facility. However, physical work on a custom-designed transformer that steps up the voltage of electricity produced at the facility to the voltage needed for transmission is physical work of a significant nature with respect to the facility because power conditioning equipment is an integral part of the activity performed by the facility.

Notice 2013-29 also details whether other types of property (roads, fences, and buildings) are integral to the activity, and thus considered for purposes of determining whether a taxpayer has begun construction of a facility. Roads may or may not be integral to the activity performed by the facility. An example of a road integral to the activity is an onsite road that is used for moving materials to be processed (for example, biomass) and roads for equipment to operate and maintain the qualified facility. On the other hand, roads primarily for access to the site, or roads used primarily for employee or visitor vehicles are not integral to the activity performed by the facility. Generally, fencing is not an integral part of the facility because it is not integral to the activity performed by the facility. Similarly, buildings are generally not integral parts of the facility because they are not integral to the activity of the facility.

Safe Harbor and Continuous Efforts: As an alternative to the facts and circumstances test for establishing physical work of a significant nature, Notice 2013-29 provides a safe harbor. Under the safe harbor, construction of a facility will be considered as having begun before January 1, 2014, if (1) a taxpayer pays or incurs (within the meaning of Treas. Reg. § 1.461-1(a)(1) and (2)) 5 percent or more of the total cost of the facility before January 1, 2014, and (2) thereafter, the taxpayer makes continuous efforts to advance towards completion of the facility (the "continuous efforts" test).

In determining the total cost of the facility, a taxpayer takes into account all costs properly included in the depreciable basis of the facility to determine whether it has met the safe harbor. The total cost of the facility does not include the cost of land or any property not integral to the facility. Notice 2013-29 addresses the situation of cost overruns and provides two examples on this point.

Similar to the Section 1603 Program guidance, Notice 2013-29 provides a look-through rule for applying the "economic performance" test of section 461(h), which governs when a taxpayer has incurred an item for tax accounting purposes. Solely for purposes of this notice, for property that is manufactured, constructed, or produced for the taxpayer by another person under a binding written contract with the taxpayer, costs incurred with respect to the property by the other person before the property is provided to the taxpayer are deemed incurred by the taxpayer when the costs are incurred by the other person under the principles of section 461. This rule is detailed in an example in Notice 2013-29.

Similar to the continuous construction test under the physical work method, Notice 2013-29 bases the determination of whether a taxpayer has satisfied the continuous efforts test on the relevant facts and circumstances. The Section 1603 Program guidance did not contain a continuous efforts test in its safe harbor, but the statute required that the property be placed in service by certain termination dates, which effectively required completing construction in a timely manner. Because ATRA removed the deadline for completing construction and placing a facility in service when it introduced the "beginning of construction" expiration date to sections 45 and 48, we thought it was appropriate to add a continuous efforts test to the safe harbor in Notice 2013-29. Given that the safe harbor looks at costs and not whether physical work has actually begun, the continuous efforts test provides an appropriate backstop to ensure that projects are not delayed for an indefinite period of time. Without an appropriate backstop, a situation could arise where after incurring 5 percent of the total costs in 2013, a developer puts a project on hold for a decade, and then in 2023, the developer starts work again and places the facility in service in 2024. In such a situation, it does not seem appropriate to allow the developer to qualify for the PTC or the ITC in 2024.

Notice 2013-29 provides a non-exclusive list of facts and circumstances indicating continuous efforts: (a) paying or incurring additional amounts included in the total cost of the facility; (b) entering into binding written contracts for components or future work on construction of the facility;(c) obtaining necessary permits; and (d) performing physical work of a significant nature. Also, similar to the continuous construction test under the physical work test, certain disruptions in the taxpayer's continuous efforts that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to make continuous efforts. The list of examples of such disruptions provided in Notice 2013-29 is the same as provided for the continuous construction test.

Notice 2013-60: Clarification to Notice 2013-29

The Treasury Department and the IRS recently released Notice 2013-60 on September 20, 2013 (to be published in the Internal Revenue Bulletin on October 15, 2013) to further clarify the beginning of construction requirement.

Continuous Construction and Continuous Efforts Tests: After releasing Notice 2013-29, the Treasury Department and PSI received questions about the application of the beginning of construction methods, and in particular the continuous construction test and the continuous efforts test. We released Notice 2013-60 to answer these questions.

Notice 2013-60 treats a facility as having satisfied the continuous construction test (for purposes of the physical work method) or the continuous efforts test (for purposes of the safe harbor) so long as the taxpayer places the facility in service before January 1, 2016. In adopting this deemed satisfaction rule, we considered both the elimination of placed in service requirements by Congress and taxpayers' need for clarity in applying the begin construction requirement. By providing this bright-line deemed satisfaction rule for both the continuous construction and continuous efforts tests, Notice 2013-60 balances the extension and change to beginning of construction in ATRA with renewable energy project developers' need for certainty to assure investors that their facilities will qualify for the PTC or ITC. It is important to note that the pre-January 1, 2016 placed in service alternative is merely a deemed satisfaction rule (or safe harbor), and that a facility may qualify for the applicable credit under the usual continuous construction/continuous efforts tests even if the taxpayer does not place the facility into service before January 1, 2016. More specifically, Notice 2013-60 provides that if a facility is not placed in service before January 1, 2016, whether the facility satisfies the continuous construction test or the continuous efforts test will be determined by the relevant facts and circumstances.

Transfer of a Facility: A taxpayer that invests in a renewable energy project after its construction has begun needs to know that they can qualify for the PTC or ITC once the facility is placed in service. Developers of renewable energy projects have difficulty attracting investors without this certainty. The Section 1603 Program guidance provided specific rules regarding transfers of a facility or an interest in an entity owning a facility, but Notice 2013-29 did not. Taxpayers expressed concern regarding this lack of guidance in the context of the PTC or the ITC.

Notice 2013-60 clarifies that the transfer of a facility after construction has begun will not prevent a facility from qualifying for the PTC or ITC. The statutory language in section 45(d) requires only that construction of a facility begin before January 1, 2014. It does not require the construction to be begun by the taxpayer claiming the credit. If a qualified facility satisfies either the physical work of a significant nature test or the Safe Harbor, a taxpayer that owns the facility during the 10-year period beginning on the date the facility was originally placed in service may claim the PTC with respect to that facility even if the taxpayer did not own the facility at the time construction began. Alternatively, a taxpayer that owns the facility on the date it is originally placed in service may elect to claim the ITC in lieu of the PTC with respect to that facility even if the taxpayer did not own the facility at the time construction began.

Conclusion

This concludes my testimony and I would be happy to answer any questions that you might have about these credits or the Notices.