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Community Development Finance Alert

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Begun construction considerations in May 2025

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Learn how to meet the IRS's "begun construction" rules for tax credits in 2025 and secure your project's eligibility amid changing legislation.

What's the impact?

- Under new legislative proposals, projects must begin construction within strict timeframes to qualify for tax credits.
- The 5% safe harbor and physical work tests are the main IRS-approved methods to prove construction commencement.
- Continuity of work and proper documentation are essential to maintain eligibility for tax credits.

In pending legislation, the House of Representatives would scale back most of the energy credits and transaction structures that were part of the Inflation Reduction Act. The bill provides certain tests for establishing whether a project continues to qualify for particular tax credits or transaction structures. While the original proposal of the Ways and Means Committee (dated May 12) had longer phase outs for the ITC, generally based on when a project is ***placed in service,*** the bill that finally passed in the House requires a project to "***begin construction***" within a very short time frame, 60 days after the date of enactment, as well as be placed in service

no later than December 31, 2028. If the House legislation becomes law (and that continues to be a big if), then it is crucial that projects begin construction in the near future.

Two further notes: the Senate will likely make changes to the House's proposal, so it is still possible that the begun construction tests in final legislation will have longer deadlines. Finally, we don't know for certain that the words "begun construction," as administered by the Trump administration, won't be subject to different rules than are now associated with existing IRS guidance, although that seems unlikely.

How to establish begun construction

With that out of the way, to establish begun construction under existing IRS guidance, there are two possible techniques—(a) the "5% safe harbor" and (b) the "significant physical work test." Before I go into these two tests, I'll note that regardless of which is chosen, the project developer must work "continuously" toward completion. There are two sub-rules on continuity. First, the IRS has provided a long list of exceptions that don't break continuity, including weather, labor stoppages, permitting delays and financing delays of not more than 6 months. Second, the IRS has provided yet another safe harbor: if the project is placed in service not later than the end of the fourth year after the year that construction began, then the project will be considered to have satisfied the continuity requirement. For example, if a project begins construction in 2025, then it must be placed in service by the end of 2029 to satisfy this safe harbor, that being the current year and then four more years, presuming that the taxpayer is on a calendar tax year. If the project is placed in service after that date, then the sponsor must actually demonstrate continuity ***throughout the period of construction***, presumably with a diary, photographs, and similar evidence and record-keeping, taking advantage of the permitted exceptions if needed.

And now the two methods for establishing that construction has begun:

The 5% safe harbor

To meet the 5% safe harbor:

- The project should have a budget, specifying the anticipated cost.
- The project sponsor should enter into a "binding written contract" with one or more service providers, developers, or vendors as follows:
  - The contract is to provide products and/or services associated with the project of at least 5% of project cost.
  - To count toward the 5% test, these products and/or services should be items which would be included in tax credit basis when the project is placed in service, and not preliminary services, such as clearing land or studies in anticipation of a possible project.
  - The contract should be entered into before the services or products called for in the contract have been provided.

- The contract should call for damages of not less than 5% of the amount of the contract if the person buying the services or product chooses to cancel the contract.
- Regardless of how much is "put down" by the buyer, it should be clear that buyer is "good" for the payment due under the contract.

- Pursuant to the one or more written contracts described above, services should be rendered, or products should be delivered to, or set aside for, the sponsor in an amount equal to at least 5% of project cost.

If these steps are taken, then the project should be considered to have begun construction on the date the services are rendered or the products are delivered. Note that the rendering of services or delivery of products is very important here. Merely paying for the services or products is not good enough, unless the taxpayer is on the cash method of accounting, which is never the case in projects of any size.

FINER POINTS TO UNDERSTAND ABOUT THE 5% SAFE HARBOR

Note a few things:

- Tax counsels generally conclude that transferring title to the buyer and then having the product(s) stored for the benefit of the buyer, even if not at the buyer's premises, or put on a boat for delivery to the buyer, can constitute delivery provided the buyer is now responsible if the goods are lost or otherwise not delivered. We normally expect the buyer to carry insurance in these cases, to establish that it is the one bearing the risk of loss.
- It is common for the 5% test to be passed with goods (as opposed to services).
- It is common for the buyer to incur more than 5%, to address the possibility of a cost overrun, and similar concerns.
- You will note that arguably, a very small amount of money could be at risk here. The buyer has to buy 5% of the cost of the project using a contract that only requires the buyer to have 5% damages. So, suppose a $100M project with a contract to purchase $6M of credit-eligible components which are then delivered before the effective date of any change in law, and the buyer pays $100,000 in forfeitable cash, plus agrees to pay an additional $250,000 of damages if the buyer cancels the contract. Note that the actual requirements to show that you have begun construction of a $100M project using the safe harbor would be 5% of $100M, or $5M, and then 5% of $5M or as little as $250,000; I used slightly higher numbers to account for "breathing room" on account of cost overruns, etc. In any case, while these numbers meet the technical requirements of the law, they are also somewhat aggressive. Of course, most sellers will not deliver $6M of components for a $100,000 downpayment and $250,000 of damages unless the buyer is "good" for the balance of nearly $6M anyway. This probably means that setting up a special purpose LLC or corporation to be the buyer, with no assets and no guarantee of a deep pocket, is at risk of not being respected.

SPECIAL 3-1/2-MONTH RULE

Finally, the5% safe harbor has a special 3-1/2-month rule, as follows:

- If Buyer and Seller enter into a contract to buy property that passes the 5% test,
- Buyer makes ***actual payment in full*** for the property, and
- Buyer "reasonably" expects that the property will be delivered ***within 3-1/2 months after payment***

Then the buyer is considered to have begun construction on the date of payment. Note a few things:

- Buyer must make payment in full to use the 3-1/2-month rule. In my previous example, that would require a payment of $6M to pass the 5% test with a little breathing room.
- The delivery date is measured from the date of payment, not the end of the year. (If buyer pays on December 15, the 3-1/2-month date would be the end of March, not the middle of April)
- Although the "official" test is based on the buyer's reasonable expectations, actual delivery within 3-1/2 months is going to be a requirement of most investors. If the parties want to enhance their claim about reasonable expectations, there should be a penalty on the seller if delivery is late, and the seller should be able to demonstrate that an under 3-1/2-month delivery time is consistent with its business practice.
- Again, we don't know if the Trump administration will endorse the 3-1/2-month rule, although we haven't heard anything to indicate that the rule might change.

The physical work of a significant nature test

The IRS also considers a project to have begun construction if there is "significant physical work" done on the project. The IRS says: "Work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in the taxpayer's trade or business (or for the taxpayer's production of income) is taken into account in determining whether construction has begun." Here are the rules:

- Both on-site and off-site work count for purposes of demonstrating that physical work of a significant nature has begun.
- Both work performed by the taxpayer and work performed by another person under a "binding written contract" (this is the same written contract entered into in advance of the work with a 5% penalty for cancelation that I described above) can count. So, a taxpayer can hire a contractor to do physical work and have that count, provided the contract complies with the binding written contract rules.

- The easiest illustration of meeting the requirements of the significant physical work test is the beginning of the excavation for the foundation, the setting of anchor bolts into the ground, or the pouring of the concrete pads of the foundation. I describe another option, referred to as "off-site manufacturing," below.
- Physical work of a significant nature ***does not include preliminary activities***, even if the cost of those preliminary activities is properly included in the depreciable basis of the facility. Preliminary activities include 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, or excavation to change the contour of the land (as distinguished from excavation for footings and foundations). Removal of existing turbines and towers is considered preliminary work and does not constitute physical work of a significant nature. Sometimes, we hear from project sponsors who don't know the rules and tell us "Oh don't worry about 'begun construction.' We have been working on this facility for years! We have permits, and a bank loan, and we have cleared all the trees and debris from the site!" And I have to tell them that none of that counts.
- The most common alternative to plainly physical work, like pouring concrete that I described above, is the manufacture of components that will become part of the facility at an off-site location, but only if
  - the manufacturer's work is done pursuant to a binding written contract (again, the same rules) and
  - these components are ***not held in the manufacturer's inventory***.

PHYSICAL WORK ELIGIBILITY

The IRS rules specifically identify the following as eligible for off-site physical work: the construction of mounting equipment and support structures, inverters, and transformers (used in electrical generation that step up the voltage to less than 69 kilovolts, i.e., not for transmission) and other power conditioning equipment. Remember that these items should be custom built and not held in inventory. Still, this test is generally not hard to pass. I'll offer that in the solar space, we often see the project sponsor order a custom transformer, the manufacturer builds a radiator that will be part of the transformer, and everyone is content that physical work has begun.

- To be eligible physical work, the property must be "integral to the production of electricity." This does not include property used for electrical transmission. For example, work on a tower for a turbine qualifies, but work on a transmission tower does not because transmission is not an integral part of producing electricity. Roads that are used for moving materials to be processed (for example, biomass) and roads for equipment to operate and maintain the

qualified facility generally qualify while roads primarily for access to the site, or roads used primarily for employee or visitor vehicles do not constitute physical work. In my experience, sponsors tend to think that ***every*** road is for "operations and maintenance," while tax advisors worry that most roads are merely for access to the site. So, roads are not the optimal kind of work to rely on. Fencing does not constitute physical work.

- Under Sections 45 and 48 (which applied to projects that began construction before 2025), beginning construction on ***even one wind*** turbine that will be part of facilities operated as a single project would pass to begin construction for ***all*** of the facilities. It appears that this rule continues under new Sections 45Y and 48E (the technology neutral counterparts to Sections 45 and 48), but there are places in the regulations for Sections 45Y and 48E that seem to break "projects" into much smaller pieces. **As of now**, I don't see a reason to be concerned that the IRS might say that "every bank of solar panels needs its own racking or every wind turbine needs its own foundation in order to begin construction," or something similar, but it may be worth paying attention to IRS guidance to see if there are updates to the existing notices.
- Three comparisons to the 5% safe harbor: (A) Don't forget that the work must not be something that would be held in inventory. Inventory can pass the 5% test, but it cannot pass the significant physical work test. (B) The 3-1/2-month rule does not apply to physical work; you cannot do physical work within 3-1/2 months of payment and date back the physical work to the earlier date. (C) While some draw comfort from the mathematical certainty of the 5% test, using the physical work test can enable a project to begin construction at a significantly smaller cost.

Maximize tax credit eligibility

As new rules and deadlines emerge, developers must navigate the complexities of begun construction requirements while also keeping projects on track and maintaining financial viability. With deep experience in structuring transactions and navigating IRS guidance, Nixon Peabody's Community Development Finance Team is well-positioned to help clients maximize tax credit eligibility while maintaining compliance in an evolving legislative landscape.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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