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IRS and Treasury Issue Proposed Investment Tax Credit Regulations for Energy Property

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The proposed regulations address, on a comprehensive basis for the first time in over 40 years, the determination of the investment tax credit for energy property under section 48. On November 17, 2023, the IRS and Treasury issued proposed regulations (the "Proposed Regulations") addressing, on a comprehensive basis for the first time in more than 40 years, the determination of the investment tax credit for energy property under section 48 (the "ITC").[1] The Proposed Regulations also revisit more recent guidance on the prevailing wage and apprenticeship requirements (the "PWA Requirements")[2] and provide guidance on other changes resulting from the Inflation Reduction Act of 2022 (the "IRA"), which made substantial adjustments to the ITC.[3] Taxpayers are permitted to rely on the Proposed Regulations until final regulations are published. This alert briefly provides background on the ITC, summarizes the primary substantive content of the Proposed Regulations, and concludes with some observations regarding key implications for taxpayers. ***Background*** ITC-eligible property includes certain solar energy property, qualified biogas property, energy storage technology, and certain other properties. Although an ITC has been available for the placement in service of qualifying energy property since 1978, the IRS and Treasury have not issued comprehensive guidance relating to the determination of energy property ITC since 1981, despite significant technological developments and material changes to section 48 in the interim. Most recently, the IRA significantly increased the types of property that are eligible for the ITC, introduced the PWA Requirements, and added ITC "adder" or "bonus" amounts for projects that meet additional requirements (*e.g.*, "energy community" siting and domestic content).[4] As a result, the ITC provisions are among the more frequently revised provisions in the Code, and the IRS and Treasury staff faced a heavy task in attempting to capture a lifetime (literally) of legal developments. The Proposed Regulations provide long-sought updates to the ITC regulations and additional guidance with respect to critical IRA provisions. ***Requirements for Energy Property*** The Proposed Regulations touch nearly every aspect of ITC determination and computation; in some instances, the Proposed Regulations appear to represent a significant departure from existing law. *Units of Energy Property and Integral Parts* The Proposed Regulations provide that ITC-eligible property includes both (1) energy property (defined to "include" a "unit of energy property," which is further defined as "all functionally interdependent components") and (2) integral parts.[5] A component of energy property is "functionally interdependent" if placing the component in service, along with the other components, is necessary to generate or store electricity, thermal energy, or hydrogen, or otherwise perform a required function. "Integral part" is defined using long-standing ITC principles (and notably would include subsea export cables to an onshore substation). *Retrofitted Property* Generally speaking, under the IRS's "80/20 rule" (which has appeared in various forms of IRS guidance), property may be treated as originally placed in service even if it contains some items of used property as long as the fair market value of the used property is not more than 20 percent of the total value of the relevant property. The Proposed Regulations make explicit the application of the 80/20 rule to ITC property, but compute the 80/20 rule by reference to the "unit of energy property" under the definition described above and take into account costs paid or incurred with respect to "integral parts" for ITC purposes only if the 80/20 rule is satisfied with respect to the "unit of energy property." Importantly, subject to limited

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exceptions, the Proposed Regulations make clear that modifications or improvements to existing energy property are not eligible for the ITC unless the 80/20 rule is satisfied. *Fractional Interest / Multiple Owners Rule* The Proposed Regulations introduce a new rule providing that a taxpayer must own at least a fractional interest in an *entire* "unit of energy property" to claim the ITC in respect of any component of that energy property. Put differently, the ITC is disallowed if, for example, a taxpayer owns only one or more components (but less than all) of a "unit of energy property." For purposes of this rule, "related taxpayers" (*i.e.*, members of a group of trades or businesses that are under common control under Treas. Reg. § 1.52–1(b)) are treated as a single taxpayer.[6] *Dual Use Property* Under the existing regulations, if property uses energy from both qualifying sources and nonqualifying sources, the eligibility of the property for the ITC depends on the annual percentage of energy used from qualifying sources. Above a threshold percentage (computed with respect to each applicable year), the ITC is determined on a proportionate basis; below the cliff threshold percentage, the ITC is disallowed. In response to numerous taxpayer requests, the Proposed Regulations lower the cliff threshold percentage for ITC eligibility from 75 percent to 50 percent. Before the IRA, the dual use property rule was particularly onerous for determining the ITC eligibility of energy storage technologies, but the Proposed Regulations confirm that the IRA effectively overrode the dual use property rule for energy storage technologies. ***Categories of Energy Property*** In addition to simply updating the existing regulations for changes to the Code, the Proposed Regulations provide new guidance defining both new and existing categories of energy property. Certain of these categories are discussed below. *Energy storage technology*. The Proposed Regulations would provide several critical clarifications regarding ITC-eligible energy storage technology:

- *Ammonia, methanol, and other hydrogen carriers*: The preamble indicates that ITC-eligible hydrogen energy storage property includes storage via a "material based" medium (which may include forms of ammonia and methanol) or a "physical based" storage medium, provided that the storage is used solely for the production of energy (including the production of heat, the generation of electricity, or the use in a fuel cell vehicle) and not for the production of end products, such as fertilizer

- *Rechargeable electrochemical batteries and "second life" batteries*: Rechargeable electrochemical batteries of all types would be ITC eligible. "Second life" battery components would be counted in determining whether an improvement to energy storage technology is ITC eligible, but, as is required by the Code, only if the modifications to the energy storage technology satisfy the statutory threshold applicable to that modified energy storage technology.[7] The IRS and Treasury separately are continuing to consider whether "second life" batteries should be considered new components for purposes of the 80/20 rule (discussed above).

Qualified biogas property. ITC-eligible qualified biogas property is defined in the Code as property comprising a system that converts biomass into a gas that is not less than 52 percent methane and captures the gas for sale or productive use (rather than for disposal by combustion), including any cleaning and conditioning property that is part of such a system. Notwithstanding the statutory reference to cleaning and conditioning property, however, the definition in the Proposed Regulations expressly excludes gas upgrading equipment, which generally concentrates the biogas (through removal of other gases such as carbon dioxide, nitrogen, or oxygen) into a mixture for injection into a pipeline.[8] *Geothermal property*. The Proposed Regulations would clarify that ITC-eligible geothermal energy property includes production wells, injection wells, monitoring wells, and certain electricity generating equipment (for those projects that convert geothermal energy to electricity).[9] Consistent with the existing ITC regulations, distribution equipment also would be included as geothermal property under the Proposed Regulations.[10] *Electrochromic glass*. The Proposed Regulations confirm statements in the legislative record that ITC-eligible electrochromic glass includes the full controls package, the electrochromic glass coating, as well as window and installation components (including glass, flashing, framing, and sealants). The Proposed Regulations add that windows incorporating electrochromic glass must be rated in accordance with the National

Fenestration Rating Council (NFRC) and that secondary glazing systems must be rated in accordance with the Attachments Energy Rating Council (AERC) Rating and Certification Process. *Co-located property*. The Proposed Regulations, like the Code, make clear that no ITC may be claimed in respect of any property that is part of a qualified facility generating section 45 production tax credits ("PTCs"). This prohibition makes delineating between an energy property (on which ITC is claimed) and a qualified facility (on which PTCs are claimed) of critical importance. Nevertheless, the Proposed Regulations provide that property that is shared by a PTC facility and an ITC property and that is an integral part of the ITC property will not be excluded from ITC qualification under this rule. An example in the Proposed Regulations illustrates the rule (or, perhaps, the exception to the rule) in the case of a PTC-eligible wind generation facility and an ITC-eligible energy storage property that share power conditioning and transfer equipment (which is integral to the energy storage property). The example explains how to allocate the cost of the power conditioning and transfer equipment between the wind generation facility and the energy storage property (for purposes of determining eligible ITC basis) and concludes that the shared integral equipment is ITC eligible (to the extent of the eligible basis) and that, because the shared equipment is not considered part of the PTC facility, the wind facility is eligible for PTCs. ***Apprenticeship Requirements for Alteration and Repair*** The Proposed Regulations would withdraw and re-propose portions of the proposed regulations issued with respect to the PWA Requirements in August 2023. Under the IRA, other than certain grandfathered and statutorily excepted projects, a taxpayer seeking to claim the full (*i.e.*, 30 percent, before adders) ITC generally must satisfy the PWA Requirements, including with respect to any alteration or repair of the ITC property during the five-year period beginning after the property is placed in service. Statutory cure provisions are available in the case of certain PWA Requirement failures, and if a taxpayer fails to cure a prevailing wage requirement failure during the recapture period, the unvested portion of the ITC would be subject to recapture. (Generally, 20 percent of the ITC fully vests every year, including the ITC "increase" for satisfying the PWA Requirements.) The Proposed Regulations would eliminate the recapture requirements for failing to satisfy the apprenticeship rules with respect to alteration and repair during the recapture period.[11] ***"Energy Project" for PWA Requirements, Domestic Content, and Energy Community Rules*** The PWA Requirements, the "domestic content" adder, and the "energy community" adder are applied with respect to an "energy project," which is defined by the IRA as one or more energy properties that are operated as part of a single energy project. The Proposed Regulation would provide that multiple energy properties will be treated as an "energy project" if, at any time during the construction of the multiple energy properties, they are owned by a single taxpayer (together with any "related taxpayers") and any two or more of the following factors are present:

1. The energy properties are constructed on contiguous pieces of land;
2. The energy properties are described in a common power purchase, thermal energy, or other off-take agreement or agreements;
3. The energy properties have a common intertie;
4. The energy properties share a common substation or thermal energy offtake point;
5. The energy properties are described in one or more common environmental or other regulatory permits;
6. The energy properties are constructed pursuant to a single master construction contract; or
7. The construction of the energy properties are financed pursuant to the same loan agreement.[12]

The Proposed Regulations also provide that, if multiple energy properties are treated as a single energy project under the begun construction rules (described in the preceding footnote), the multiple energy properties also will be treated as a single energy project for purposes of the PWA Requirements, the "domestic content" adder, and the "energy community" adder. ***Commentary***

- The Proposed Regulations are a welcome development, but the guidance they provide is incomplete, especially without corresponding, fulsome recapture guidance (which, in its current form, is even more outdated than the existing ITC regulations). For example, the Proposed Regulations' definition of a "unit of energy property" applies for purposes of (1) defining ITC-eligible property that does not need to separately satisfy the "integral" requirement, (2) applying the 80/20 rule, and (3) applying the new "fractional interest" rule. However, unlike the Code's other "unit of property" rules (*g.*, under sections 168 and 263A), this "unit of energy property" confusingly may not be the same unit of property with respect to which the ITC is actually determined or, critically, subjected to recapture.[13] Recapture guidance for circumstances in which damaged property is replaced is especially needed (in particular, in light of revisions to the 80/20 rule discussed below).

- The Proposed Regulations state that "buildings (also referred to as structures) are generally not integral parts of an energy property because they are not integral to the activity of the energy property," and then import part of a pre-1986 regular investment tax credit rule to define potentially "integral" buildings that are ITC-eligible.[14] However, any generalization against energy ITC-eligibility for buildings is not supported by the Code; buildings (and structural components) have been explicitly eligible (without qualification) for the energy ITC since it was enacted in 1978 (a point reiterated in the regulations since 1981), an effort by Congress to save taxpayers seeking the energy credit for building components from having to satisfy the exact rules to which the Proposed Regulations would subject them.[15] Indeed, several ITC-eligible properties are themselves building components.

- Applying the 80/20 rule with respect to the ITC on a "unit of energy property" basis may represent a potentially significant change from present law, although its full effect is unclear without additional recapture guidance.[16] For example, although not as well developed as guidance under sections 168 or 263A, existing ITC guidance and rulings generally have analyzed the ITC qualification (and recapture) of replacement parts and improvements on a separate property-by-property basis.

- The Proposed Regulations include welcome clarification that has been sought for several years by the offshore wind industry, making clear that ITC eligible property includes all property from the turbine downstream to onshore transformer and switchgear, including clarification that subsea export cables would qualify for the ITC.

- The new fractional interest / multiple owners rule creates a massive new cliff-effect trap that will require taxpayers to be certain they own at least a fractional interest in the *entire* "unit of energy property" or otherwise risk total disallowance. The rule directly conflicts with the Tax Court's decision in *Cooper v. Commissioner*;[17] it may be that the "unit of energy property" rules (described above) are intended to overrule that decision, although there is no mention of this intent in the preamble. This rule is likely to have an outsized impact on certain types of projects, including landfill gas projects, that are more likely to have different components of the project owned by different owners.

- Although an example in the Proposed Regulations shows the ITC being claimed in respect of a battery that is co-located with a PTC facility, given the high stakes, further clarification would be helpful. For example, is a battery that is co-located with a PTC facility eligible for ITC even where the battery is not connected to the grid and is charged solely from the PTC facility (*e.*, is arguably "integral" to the PTC facility)? Given the "integral part" framework of the Proposed Regulations and that a battery and a co-located PTC facility may represent separate projects, we believe it would be appropriate to adopt a bright-line rule specifying that energy storage property is eligible for the ITC even where the "unit of energy property" is integral to a co-located PTC facility.

- Under the revised definition of "energy project," which expressly excludes a facility on which PTC is claimed, it is curious that the decision about whether to claim PTC or ITC on a generation facility could have a material impact on the availability of certain credit adders, such as the domestic content adder, even for identical project configurations. (In particular, if PTC is claimed on the generation facility, then the generation facility and battery are independently tested. If, on the other hand, ITC is claimed on the generation facility, then the generation and battery are jointly tested.) A rule allowing for independent assessment of whether each particularly type of energy property is eligible for an adder would provide a more cohesive set of rules.

- Application of the expansive "energy project" rules to the PWA Requirements, the "domestic content" adder, and the "energy community" adder (and, in particular, the "related taxpayer" rule) will make satisfaction of these requirements more challenging and will introduce new diligence and documentation hurdles.

- The exclusion of gas upgrading equipment from the definition of qualified biogas property surprised many market participants (as it is arguably at odds with both the text of section 48 and analogous guidance) and is uncertain in scope. The preamble states that gas upgrading equipment is not a "functionally interdependent" component of qualified biogas property (and, therefore, implicitly not a "unit of [qualified biogas] energy property"). Unfortunately, the Proposed Regulations do not address whether gas upgrading equipment could be an "integral part" of qualified biogas property, *e.* whether gas upgrading equipment is used directly in the intended function of qualified biogas property and is essential to the completeness of the intended function.[18] Under this framework, gas upgrading equipment would seem to be an integral part of a single process to prepare biogas for sale or productive use; if the IRS and Treasury intended to signal that gas upgrading equipment needed to satisfy the "integral part" analysis (as it did with other equipment), would be helpful if they make that intent clearer.

Effective Date The Proposed Regulations generally apply with respect to property placed in service during a taxable year beginning after the regulations are final, although (1) taxpayers may rely on these Proposed Regulations for taxable years beginning after December 31, 2022 and (2) the Proposed Regulations relating to the PWA Requirements apply to projects that begin construction after the date final regulations are published (except that the "energy project" rule applies to projects on which construction begins after November 22, 2023). ___________ [1] Unless indicated otherwise, all section references are references to the Internal Revenue Code of 1986, as amended (the "Code"), and references to "regulations" are references to those regulations promulgated under the Code. [2] Please see our previous alert on the proposed regulations addressing the PWA Requirements, which is found here. [3] As was the case with the so-called Tax Cuts and Jobs Act, the Senate's reconciliation rules prevented Senators from changing the Act's name, and the formal name of the so-called Inflation Reduction Act is actually "An Act to provide for reconciliation pursuant to title II of S. Con. Res. 14." [4] Please see our previous client alerts on these adders, which can be found here and here. [5] "Integral parts" of energy property have been ITC-eligible since the energy credit was enacted in 1978, although the "integral part" language was not included in section 48 when the ITC statute was amended in 1990 for the gradual elimination of the regular investment tax credit that began in 1986. A reference to "integral parts" was included in section 48(a)(5) (election to claim the ITC for PTC facilities) when it was later enacted, and the statutory gap will be filled entirely when the ITC transitions to the technology neutral tax credit under section 48E in 2025. [6] The preamble observes that "related taxpayer" is neither defined in section 48 nor did the IRS or Treasury receive comments regarding the "related taxpayer" rule in response to Notice 2015–70. Some further explanation may help clear up the confusion (and give an indication of the drafting task facing the IRS and Treasury): "Related taxpayer" is not defined in section 48 because it is not used in section 48; the language was removed, along with the rule to which it related, in 1990. The IRS and Treasury did not receive comments regarding the "related taxpayer" rule in response to Notice 2015–70 for that reason (and also because the IRS and Treasury did not ask for any such comments). [7] Although improvements are generally not ITC eligible unless the modified property satisfies the 80/20 rule under the Proposed Regulations, modifications to energy storage technologies are subject to special statutory rules. [8] In addition, the Proposed Regulations state that methane measurement would occur at the point at which gas exits the biogas production system, but likely before the biogas enters the gas upgrading equipment. [9] Under the Proposed Regulations production equipment does not include equipment used for exploration and development of geothermal deposits. [10] Distribution equipment generally is defined as equipment that transports geothermal energy from a geothermal deposit to the site of ultimate use. As is the case with the existing ITC regulations, however, geothermal property would not include any electrical transmission equipment. [11] The cross-references in Prop. Treas. Reg. § 1.6418-5(f)(2) and Prop. Treas. Reg. § 1.6418-5(f)(3) to Prop. Treas. Reg. § 1.48-13(c)(3)(D) and to Prop. Treas. Reg. § 1.48-13(c)(3)(B), respectively, appear to have been intended as cross-references to Prop. Treas. Reg. § 1.48-13(c)(4) and to Prop. Treas. Reg. § 1.48-13(c)(3)(ii), respectively. [12] Notice 2018-59 included a similar list of "single project" factors for purposes of determining whether construction had begun on a project, but did not contain the same numerical, two-factor threshold. [13] Perhaps the single most persistent complaint we hear from clients involved in energy transition activities is the Code's and Regulations' inconsistent use of the critical IRA terms "project," "facility," "property," and "component." The Proposed Regulations may add "unit" to the list. [14] Like the "unit of energy property" rule, this aspect of the Proposed Regulations appears to have its origins in Notice 2018-59, which is taxpayer-friendly guidance that addresses when construction began on ITC-eligible property but does not provide guidance as to what constitutes ITC-eligible property. [15] This rule changes beginning in 2025, when buildings and their structural components become ineligible for the ITC under section 48E. [16] Once again, this aspect of the Proposed Regulations appears to have been based on Notice 2018-59, which did not provide guidance for ITC eligibility. [17] 88 T.C. 84 (1987). [18] In contrast, the Proposed Regulations regarding electricity-generating property would treat analogous "power conditioning" and "transfer equipment" as integral.

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