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Treasury Issues Proposed Regulations on the Definition of "Energy Property" and Rules Applicable to the Section 48 Energy Credit

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The Inflation Reduction Act of 2022 made significant modifications and additions to the energy credit available under Section 48 of the U.S. Internal Revenue Code of 1986, as amended (the "Code" and such credit, the "Section 48 ITC"). In response to these legislative modifications, the U.S. Treasury has recently released proposed regulations (the "Proposed Regulations") that aim to revise the existing regulations governing the Section 48 ITC. The Proposed Regulations focus in part on providing clarity regarding the definition of "energy property" and delineating the specific costs eligible for inclusion in the basis of energy property for purposes of calculating the Section 48 ITC. In addition, the Proposed Regulations would clarify the application of credit transferability rules described in prior guidance to the recapture rules applicable to projects that fail to satisfy certain prevailing wage and apprenticeship requirements.

Defining "Energy Property"

The amount of the Section 48 ITC that a taxpayer may claim is determined in part on the basis of the "energy property" that that taxpayer places in service during a taxable year.

Defining Energy Property Generally

Code Section 48 outlines certain requirements that property must satisfy in order to qualify as energy property. The Proposed Regulations expand on those requirements:

- *The taxpayer constructs, reconstructs, or erects the property, or, if the original use of the property commences with the taxpayer, acquires the property*. Under the Proposed Regulations, "construction, reconstruction, or erection of energy property" would mean work performed to construct reconstruct, or erect energy property either by the taxpayer or for the taxpayer in accordance with the taxpayer's specifications. "Original use of energy property" would mean the first use which a unit of energy property is put to, whether or not that use is by the taxpayer. Special rules, described below, apply to retrofitted energy property.

- *Depreciation (or amortization in lieu of depreciation) is allowable with respect to the property*. Generally, depreciation is "allowable" with respect to an energy property under the Proposed Regulations if that property is of a character subject to the Code Section 167 allowance for depreciation and the basis or cost of that property is recovered using a method of depreciation.

- *The property meets certain performance and quality standards prescribed by the Secretary of the Treasury in effect at the time of acquisition of the property*. The Proposed Regulations include special rules for performance and quality standards for small wind energy property and electrochromic glass property. For purposes of applying performance and quality standards, the Proposed Regulations provide that the time of acquisition is the earlier of the date that (i) the taxpayer begins construction, reconstruction, or erection of the property or (ii) the taxpayer and another person enter into a binding contract requiring the other person to construct, reconstruct, or erect the property and place that property in service. A contract is binding for these purposes only if it is enforceable under state law against the taxpayer and does not limit damages to an amount less than 5% of the total contract price. This definition mirrors that applicable under rules under IRS notices for determining when construction begins on energy property.

- *The property must be the type of energy property eligible for the Section 48 ITC*. The Proposed Regulations provide further details on the following types of energy property that qualify for the Section 48 ITC:

  - Solar energy property
  - Fiber-optic solar energy property
  - Electrochromic glass property
  - Geothermal energy property
  - Qualified fuel cell property
  - Qualified microturbine property
  - Combined heat and power system (CHP) property
  - Qualified small wind energy property
  - Geothermal heat pump equipment
  - Waste energy recover property (WERP)
  - Energy storage technology
  - Qualified biogas property
  - Microgrid controllers

Property That May Be Included in the Basis of Energy Property

Under the Proposed Regulations, energy property includes a "unit of energy property" that otherwise satisfies the requirements noted above. In addition, property owned by the taxpayer that is an integral part of an energy property is treated as energy property for purposes of Code Section 48.

A "unit of energy property" is defined generally to mean all functionally interdependent components of property owned by the taxpayer that are operated together and that can operate apart from other energy properties within a larger energy project. Components are "functionally interdependent"

(i) generally, if the placing in service of each component is dependent upon the placing in service of each of the other components in order to generate or store electricity, thermal energy, or hydrogen or (ii) in the case of solar process heat equipment, fiber-optic solar energy property, electrochromic glass property, geothermal heat pump equipment, qualified biogas property, and microgrid controllers, if the placing in service of each component is dependent upon the placing in service of each of the other components in order to perform the intended function of the energy property.

The Proposed Regulations provide that property owned by the taxpayer is an "integral part" of an energy property owned by the same taxpayer if it is used directly in the intended function of the energy property and is essential to the completeness of that intended function. Multiple energy properties may include shared property that may be considered an integral part of each energy property, provided that the cost basis for the shared property is properly allocated to each energy property. A cost segregation study would likely be required to support such an allocation. The total cost basis of shared property divided among the energy properties may not exceed 100% of the cost of that shared property. In addition, under the Proposed Regulations, property that is an integral part of an energy property would not fail to qualify as energy property simply because it is shared by that energy property and a qualified facility (as defined in Code Section 45).

The Proposed Regulations contain examples of types of property that are and are not an integral part of an energy property. These examples are similar to those provided in prior IRS notices, including Notice 2018-59.

Property That Is An Integral Part	***Property That Is Not An Integral Part***
▪ Power conditioning equipment, including transformers, inverters, and converters, and parts related to the functioning or protection thereof ▪ Transfer equipment, including wires, cables, and combiner boxes that conduct electricity (but not transmission or distribution lines), and parts related to the functioning or protection thereof ▪ Onsite roads used for equipment operation and facility maintenance ▪ Structures that are essentially items of machinery ▪ Structures that house property integral to the activity of an energy property, if the use of the structure is so closely related to the use of the energy property that it can be expected to be replaced when the energy property is replaced	▪ Transmission or distribution lines ▪ Roads primarily used for site access or for employee/visitor vehicles ▪ Fences ▪ Buildings (except structures described to the left)

Property That Is Not Energy Property

The Proposed Regulations also state that energy property generally does not include any property that is part of a qualified facility for which the production tax credit under Code Section 45 is or has been claimed (excluding any property that is an integral part of an energy property that is also used by a qualified facility). Moreover, under the Proposed Regulations, energy property would not include power purchase agreements, goodwill, going concern value, or renewable energy certificates which is consistent with the current industry practice with these types of properties.

One-Megawatt Exception, PWA Requirements, and PWA Recapture and Transferability

Under Code Section 48, an energy project will qualify for an increased credit amount if (i) certain wage and apprenticeship requirements (the "PWA Requirements") are satisfied with respect to the project, (ii) construction on the project began before January 29, 2023, or (iii) the maximum net output (or capacity) of the project is less than one megawatt (the "One-Megawatt Exception"). The Proposed Regulations provide additional guidance on this increased credit amount, including as applied to the transfer of the Section 48 ITC under Code Section 6418.

One Megawatt Exception

Under the Proposed Regulations, the One-Megawatt Exception is not available for electrochromic glass property, fiber-optic solar energy property, and microgrid controllers because those energy properties do not generate electricity or thermal energy. However, the Treasury Department and the IRS have requested comments on whether other methods of measurement may allow these energy properties to use the One-Megawatt Exception. We expect that a number of taxpayers will have comments on this rule, since it would likely be burdensome on developers and seems contrary to the purpose behind the one-megawatt exception.

PWA Requirements – Defining an "Energy Project"

The Proposed Regulations introduce a definition of "energy project" for purposes of the PWA Requirements: multiple energy properties will be deemed operated as part of a single "energy project" if they are owned by the same taxpayer and at least any two of the following factors are present: the properties (i) are constructed on contiguous pieces of lands, (ii) described in common power purchase or similar off-take agreements, (iii) have a common intertie, (iv) share a common substation or off-take point, (v) are described in common environmental or other regulatory permits, (vi) are constructed under a single master construction contract, or (vii) are financed under the same loan agreement. This definition differs from prior IRS guidance explaining when multiple energy properties will be treated as part of a single "energy project," which requires a facts-and-circumstances analysis considering these factors.

Recapture under PWA Requirements; Application of Transferability Rules

Code Section 48 requires the Treasury to provide for the recapture of the benefit of any increased Section 48 ITC amount allowed as a result of the application of the PWA Requirements if the applicable project fails to satisfy the PWA Requirements for the five-year period after the project is placed in service (such recapture, a "PWA Recapture"). The Proposed Regulations would introduce such PWA Recapture rules, which are similar to those applicable to a recapture under Code Section 50(a). Under the Proposed Regulations, a taxpayer whose increased credit amount is subject to a PWA Recapture would still be entitled to the base amount of the Section 48 ITC if the applicable energy property otherwise satisfies the qualification requirements to claim the credit.

The Proposed Regulations would clarify that a buyer who has purchased a Section 48 ITC under Code Section 6418 that includes an increased credit amount based on satisfaction of the PWA Requirements would be responsible for any increase in tax resulting from a PWA Recapture. In addition, the Proposed Regulations would confirm the notification requirements for the seller of the Section 48 ITC.

Retrofitted Property

In prior IRS notices, including Notice 2018-59, the IRS permitted retrofitted energy property to be considered originally placed in service for purposes of Code Section 48, provided that the fair market value of the used components of the energy property is not more than 20% of the total value of the energy property, taking into account the cost of the new components (such rule, the "**80/20 Rule**"). The Proposed Regulations would adopt the 80/20 Rule.

Dual Use Property

The Proposed Regulations also include regulations applicable to dual use property, which is defined to mean property that uses energy derived from both a qualifying source (i.e., from an energy property) and from a non-qualifying source (i.e., sources other than an energy property). Dual use property will qualify as energy property under the Proposed Regulations if its use of energy from non-qualifying sources does not exceed 50% of its total energy input. This rule is more generous than the current rule that has a 75% qualifying source threshold. However, if the energy used from qualified sources is between 50% and 100%, only a proportionate amount of the basis of the energy property will be taken into account in computing the Section 48 ITC available with respect to such dual use property. Recapture rules apply if during the five-year recapture period, the equipment's use of energy from qualifying sources falls below 50% during an annual measuring period.

Certain Lower-Output Energy Properties and Qualified Interconnection Costs

Under Code Section 48, energy property includes amounts a taxpayer pays or incurs for "qualified interconnection property" in connection with the installation of energy property with a maximum net output of not greater than 5MW (as measured in alternating current). "Qualified interconnection property" is defined to mean, with respect to an energy project (other than a microgrid controller), any tangible property (i) that is part of an addition, modification, or upgrade to a transmission or distribution system that is required at or beyond the point at which the energy project interconnects to that transmission or distribution system in order to accommodate the interconnection, (ii) that is either constructed, reconstructed, or erected by the taxpayer, or for which the cost with respect to the construction, reconstruction, or erection of such property is paid or incurred by such taxpayer, and (ii) the original use of which, pursuant to an interconnection agreement, commences with a utility.

The Proposed Regulations would provide that for purposes of this rule, the maximum net output of an energy property is measured only by nameplate generating capacity of the unit of energy property (or, in the case of energy storage technology, the nameplate capacity of such energy storage technology) at the time the energy property is placed in service. In addition, a taxpayer that is reimbursed for interconnection costs would not be permitted to include those costs in the amount paid or incurred for qualified interconnection property.

The Proposed Regulations emphasize that qualified interconnection property is not itself energy property. Accordingly, qualified interconnection property is disregarded for purposes of determining whether energy property satisfies the qualification requirements for the domestic content and energy community adders. In addition, the definition of qualified interconnection property excludes interconnection property installed with respect to microgrid controllers, and costs of qualified interconnection property associated with electrochromic glass property, fiber-optic solar energy property, and certain thermal energy-generating properties and qualified biogas property are similarly excluded.

Next Steps: Comment Period, Public Hearing, and Future Guidance

Interested parties may submit written comments on the Proposed Regulations through January 22, 2024, and a public hearing is scheduled for February 20, 2024. After the comment period closes and taxpayers have been given an opportunity to be heard at the public hearing, Treasury and the IRS will assess whether revisions to the Proposed Regulations are necessary. In the meantime, the Proposed Regulations provide taxpayers, contractors, and subcontractors constructing renewable energy projects with greater certainty as to the qualification of projects for the Section 48 ITC.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Los Angeles lawyers:

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