

IRS Issues Proposed Regulations on Energy Property and Rules Applicable to Energy Credit Under Section 48

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The IRS and the Treasury Department issued [proposed regulations under Section 48](#) on November 22, 2023 (Proposed Regulations), providing further guidance in determining whether property is energy property and eligible for the Section 48 credit (ITC). As part of this further guidance, the Proposed Regulations introduce a new framework for the definition of energy property, provide welcome clarification regarding the eligibility of energy property for multiple credits, and provide guidance on the Section 48(a)(10)(C) recapture rules applicable to failures to satisfy the prevailing wage and apprenticeship requirements (PWA requirements). Taxpayers must be aware of these energy property requirements and additional ITC eligibility guidance to ensure future eligibility for the ITC. The Proposed Regulations would amend Treasury Regulation Section 1.48-9, withdraw and replace Proposed Treasury Regulation 1.48-13 as it was proposed in REG-100908-23 ([PWA Proposed Regulations](#)), and introduce Proposed Regulation Section 1.48-14. The Proposed Regulations follow the passage of the [Inflation Reduction Act of 2022](#) (IRA) and the publication of Notice 2022-49, 2022-43 I.R.B. 321, which requested comments on issues arising under Section 48.

Proposed Regulation Sections 1.48-9 and 1.48-14 would apply with respect to property that is placed in service after December 31, 2022, and during a taxable year beginning after the date final regulations are published in the Federal Register. Proposed Regulation Section 1.6418-5(f) is proposed to apply to taxable years ending on or after the date final regulations are published in the Federal Register. A taxpayer may rely on Proposed Regulation Sections 1.48-9, 1.48-14, and 1.6418-5(f) with respect to property that is placed in service after December 31, 2022, and during a taxable year beginning on or before the date final regulations are published in the Federal Register if the taxpayer and all related persons (within the meaning of Sections 267(b) and 707(b)) apply Proposed Regulation Sections 1.48-9 and 1.48-14 in their entirety and in a consistent manner.

Generally, Proposed Regulation Section 1.48-13 would apply with respect to property that is placed in service in a taxable year ending after the date final regulations are published in the Federal Register, and the construction of which begins after the date final regulations are published in the Federal Register. However, Proposed Regulation Section 1.48-13(d) (which defines “energy project”) would apply with respect to energy projects which begin construction after November 22, 2023. A taxpayer may rely on Proposed Regulation Section 1.48-13 with respect to property or a project that begins construction on or after January 29, 2023, and on or before the date the final regulations are published in the Federal Register, provided that, beginning on October 28, 2023 (i.e., 60 days after August 29, 2023), the taxpayer applies Proposed Regulation Section 1.48-13 in its entirety and in a consistent manner.

Unit of Energy Property

The Proposed Regulations adopt a conceptual framework pursuant to which energy property is either a “unit of energy property” or an “integral part”. The Proposed Regulations would provide that a “unit of energy property” consists of all functionally interdependent components of property owned by the taxpayer that operate together and that can operate apart from other energy property within a larger energy project. Components are functionally interdependent 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.

The Proposed Regulations further provide that property that is an “integral part” of an energy property is energy property, and specify certain components that do or do not qualify as energy property by virtue of being or not being integral parts. Power conditioning and transfer equipment are specifically noted as integral parts of energy property. In an unexpected and disappointing development, the Proposed Regulations provide that energy property does not include an addition or modification to an existing energy property unless the rules regarding retrofitted energy property, described below, apply.

- Power conditioning equipment includes transformers, inverters, and converters, plus parts related to the functioning or protection of power conditioning equipment (including switches, circuit breakers, arrestors, and hardware and software used to monitor, operate, and protect power conditioning equipment). Transfer equipment includes wires, cables, and combiner boxes used to aggregate energy generated by components of energy properties, and equipment that alters voltage in order to permit transfer to a transmission and distribution line. The inclusion of inverters as “integral property” rather than components of a unit of energy property is surprising, given that Notice 2018-59, applying the same functional interdependence standard, provided that solar energy property was comprised of “all components of property necessary to generate electricity up to *and including* the inverter” (emphasis added).
- The conceptual approach in the Proposed Regulations is a shift from existing Treasury Regulation Section 1.48-9, which enumerates qualifying and nonqualifying property. Although the Proposed Regulations do not explicitly say it, the approach appears to be intended to harmonize Section 45 and Section 48. The Section 45 concept of “qualified facility” lines up with the Section 48 concept of “unit of energy property”, and “integral part” covers all of the property in an energy project that qualifies for the ITC but is not a qualified facility or unit of energy property.

Though the Proposed Regulations consistently apply the “functional interdependence” and “integral part” framework to all eligible technologies for purposes of determining what constitutes a unit of energy property, they also provide some nonexclusive lists and examples of energy property. In an example of a qualified offshore wind facility in which AC electricity generated by a turbine is carried by inter-array cables to an offshore substation where a transformer steps up the voltage and a converter converts the electricity to DC for transportation by subsea export cables to an onshore substation adjacent to the point of interconnection, the IRS provides that energy property includes all components up to and including the transformer and switchgear housed in the onshore substation. This is certainly a win for the offshore wind industry, which had concerns that some of the components discussed in the example would be treated as transmission equipment.

Renewable natural gas (RNG) did not fare as well under the Proposed Regulations, which include a nonexclusive list of RNG equipment that constitutes “qualified biogas property.” The list includes waste feedstock collection systems, landfill gas collection systems, mixing or pumping equipment, and anaerobic digesters, but specifically excludes gas upgrading equipment necessary to concentrate biogas into the appropriate mixture for injection into

a pipeline through removal of other gases such as carbon dioxide, nitrogen, or oxygen.

- It is perplexing that the Proposed Regulations would treat the gas upgrading equipment as ineligible given that analogous equipment for electricity generation and storage facilities is eligible.
- The Proposed Regulations require that the 52% methane requirement is “measured at the point at which gas exits the biogas production system,” raising the possibility that a system that meets the requirement at a later stage in the process could fail to qualify as “qualified biogas property.”
- The ownership rules that govern “units of energy property” and “integral parts” discussed below could create qualification issues for RNG projects, in which a digester is owned by one party and a pipeline by another party.

Energy Storage Technology

The Proposed Regulations provide a nonexclusive list of different types of energy storage technologies: rechargeable electrochemical batteries of all types (such as lithium ion, vanadium flow, sodium sulfur, and lead-acid); ultracapacitors; physical storage such as pumped storage hydropower, compressed air storage, flywheels; and reversible fuel cells.

Prior to the IRA, energy storage property qualified for the ITC only by virtue of its relationship to energy property (typically solar energy property) that qualified for the ITC. The Proposed Regulations would amend the definition of “solar energy property” so that it no longer includes storage devices. In addition, as noted below, the Dual Use Rule is no longer relevant to determining the eligibility of energy storage technology placed in service after December 31, 2022.

Qualified Interconnection Property

The IRA provided that energy property includes amounts paid or incurred by a taxpayer for “qualified interconnection property” in connection with the installation of energy property with a maximum net output of not greater than 5 MW(ac). The Proposed Regulations define qualified interconnection property as any tangible property that is part of an addition, modification, or upgrade to a transmission or distribution system that is required at or beyond the point in which the energy project interconnects to the transmission or distribution system and clarify that qualified interconnection property is not part of an energy property. As a result, qualified interconnection property is not taken into account in determining whether energy property satisfies the domestic content requirements or qualifies for the energy community bonus credit.

- Given the clarification with respect to the bonuses, it is surprising that the Proposed Regulations do not address whether qualified interconnection property must satisfy the PWA Requirements. The logical conclusion of the fact that qualified interconnection property is not energy property is that the construction, alteration, or repair of qualified interconnection property does not need to satisfy the PWA Requirements. Nevertheless, because the Proposed Regulations do not specifically address the matter, some uncertainty remains for taxpayers.

To be included in the basis of energy property, costs for qualified interconnection property must be properly chargeable to the capital account of the taxpayer. Costs that are reimbursed to the taxpayer may not be included. Guidance is requested with respect to the appropriate treatment of payment, credits, or services received by a taxpayer from a utility as a result of subsequent payments made to the utility by other parties, and on the proper

treatment of the subsequent payments themselves. Guidance is also requested with respect to industry practice for the determination of qualified interconnection property costs.

The Proposed Regulations provide that the 5MW(ac) limitation is measured by reference to a “unit of energy property” rather than an entire “energy project,” which leaves open the possibility that much larger projects could have qualified interconnection property.

Co-location of Energy Projects and Qualified Facilities

The Proposed Regulations provide welcome clarification that the production tax credit (PTC) may be claimed on electricity generated by qualified facilities co-located with energy projects for which ITC is claimed. Power conditioning and transfer equipment shared by qualified facilities and energy property may be treated as an integral part of the energy property for purposes of the ITC. The sharing of the equipment does not impact the ability of a taxpayer to claim the ITC for the full cost of the energy property or the PTC for electricity generated by the qualified facility.

Recapture for Failure to Meet Prevailing Wage Requirements

The Proposed Regulations withdraw Proposed Treasury Regulation Section 1.48-13, as introduced in the PWA Proposed Regulations and repropose a new Section 1.48-13. The new Section 1.48-13 clarifies that a taxpayer that has claimed an increased ITC amount as a result of satisfying the PWA requirements, but fails to satisfy the prevailing wage requirements with respect to any recapture year during the five-year period beginning on the date a project is placed in service, is subject to recapture of a portion of the increased ITC. Each 365-day period, or 366-day period in the case of a leap year, within the five-year recapture period is a separate recapture year. Taxpayers may continue to utilize the correction and penalty provisions in Proposed Treasury Regulation Section 1.45-7(c)(1) to cure failures to pay prevailing wage within the five-year recapture period.

The Proposed Regulations also clarify that for ITCs transferred pursuant to the [transferability rules](#), in the event of recapture for failure to satisfy the prevailing wage requirements, the eligible taxpayer (*i.e.*, the transferor) must notify the transferee taxpayer of the recapture event, and the transferee is responsible for the recapture tax.

- Many taxpayers have asked for clarification as to whether the apprenticeship requirements apply to alteration and repair after an energy project (for ITC) or a qualified facility (for PTC) is placed in service. By defining a recapture event for ITC in this context as a failure to satisfy the prevailing wage requirements, the Proposed Regulations imply, but do not explicitly state, that satisfaction of the apprenticeship requirements during the recapture period is not necessary to avoid recapture. It is not clear whether this will be enough of a clarification to provide comfort that apprentice labor need not be utilized after a project is placed in service.
- Though recapture years are determined based on the placed-in-service date, the Proposed Regulations provide that whether a recapture event has occurred is determined at the close of a taxable year that begins or ends within the five-year recapture period. Annual information reporting on forms prescribed by the IRS verifying compliance with the prevailing wage requirements following the close of the recapture year will be required.

Energy Project

The IRA introduced the term “energy project,” which is defined in the Proposed Regulations as a project

consisting of one or more energy properties that are operated as part of a single project. Prior IRS guidance has applied the “single project” concept as a facts-and-circumstances test, in which several factors are considered.

The Proposed Regulations update the “single project” factors to be technology-neutral:

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

The Proposed Regulations also take a different approach with respect to the application of the “single project” factors, providing that multiple energy properties would be treated as one energy project, if *at any point during the construction of the multiple energy properties*, they are owned by a single taxpayer (or by taxpayers under common control within the meaning of Treasury Regulation Section 1.52-1(b)) and any two or more of the single project factors are present.

The Proposed Regulations clarify that if multiple properties are treated as a single project for purposes of the “beginning of construction” test, they are treated as a single project for purposes of the PWA requirements, the domestic content bonus credit amount, and the energy community bonus credit amount.

- The pivot from treating the “single project” factors as a facts-and-circumstances test in which no factor or group of factors were determinative, to a checklist that is determinative if any two factors are satisfied is a significant departure from past IRS guidance, which will make the test both easier to apply and easier for taxpayers to control.
- The practical implication of the change is that any projects that are located on a contiguous piece of land and share interconnection rights are treated as a single project if they are owned by a single developer when construction begins. This could have unfortunate consequences in a situation where a developer sells early-stage projects that share interconnection rights to different purchasers (e.g., the domestic content bonus credit could not be claimed on a project-by-project basis).
- The change in approach is particularly curious given that Treasury and the IRS recently chose to apply the single project test as a pure facts-and-circumstances test in the final regulations for the low-income community bonus for ITC, which means that different single projects tests would apply to different paragraphs within Section 48. This will undoubtedly create confusion in the market.

Dual-Use Property

Existing Treasury Regulations include a rule (Dual Use Rule), under which property is eligible for the ITC only if the use of energy from a qualified source is at least 75% of the total energy input during an annual measuring period and only to the extent of the property's basis or cost allocable to its annual use of energy from a qualified source. The Proposed Regulations retain the Dual Use Rule but change the so-called 75% cliff to a 50% cliff.

- Prior to the IRA, the Dual Use Rule applied to batteries eligible for the ITC as part of qualifying solar or wind energy properties. The Preamble to the Proposed Regulations states that Treasury and the IRS recognize that the Dual Use Rule is no longer relevant to determining the eligibility of energy storage technology placed in service after December 31, 2022, because the IRA added energy storage technology as standalone energy property.

Incremental Cost

The Proposed Regulations provide that only the incremental cost of energy property is included in the eligible basis for ITC. The term "incremental cost" means the excess of the total cost of energy property over the amount that would have been expended for the energy property if the energy property were not used for a qualifying purpose. The Proposed Regulations include an example of bifacial solar panels installed over a reflective roof. Only the incremental cost of the reflective roof over the cost of a standard roof is included in the eligible basis of the energy property.

- The Preamble notes that the incremental cost rule is in the existing ITC regulations and suggests that the Proposed Regulations simply continue to apply the rule. However, under the existing regulations, the incremental cost rule has a limited application and, in particular, it does not apply to solar or wind energy property. The Proposed Regulations' broad use of the rule in the context of all energy property is therefore a significant expansion of the existing regulations. While not likely to have a meaningful impact in the context of utility-scale projects, the incremental cost rule could require difficult determinations to be made regarding what the incremental cost is in the context of rooftop or carport solar installations.

Multiple Owners

If multiple taxpayers directly own an energy property (e.g., as tenants in common), the Proposed Regulations require that each taxpayer determine its eligible basis based on its fractional ownership interest in the energy property. While the foregoing rule is not surprising and is consistent with IRS rulings and case law, the Proposed Regulations go beyond that and require that a taxpayer (or one or more related taxpayers) must own at least a fractional interest *in the entire unit of energy property* for an ITC to be determined with respect to such taxpayer's interest. Thus, if a taxpayer owns some but not all components of an energy property that constitute an entire unit of energy property, the taxpayer is not eligible for ITC with respect to the components; in fact, no one is. Moreover, if a taxpayer owns a unit of energy property and a second taxpayer owns property that is an integral part of that energy property (and is not an integral part of other energy property), this does not prevent the first taxpayer from claiming ITC with respect to its energy property, but the second taxpayer may not claim an ITC with respect to the integral part.

- The multiple ownership rules in the Proposed Regulations are baffling. They are inconsistent with the statute (which has no such limitations), caselaw, and prior Treasury Department guidance under Section 1603. It is not clear what policy the IRS had in mind or what potential abuse the rule is intended to address.

Retrofitted Property

The Proposed Regulations would apply the so-called “80/20 Rule” to determine whether a retrofitted “unit of energy property” qualifies as originally placed in service even if it contains some used components of property. Under the 80/20 Rule, a unit of energy property may be originally placed in service only if the fair market value of the used components of the unit is not more than 20% of the total value of the unit, taking into account the cost of the new components and the value of the used components. Only expenditures paid or incurred relating to the new components are taken into account for purposes of computing the ITC. If the taxpayer satisfies the 80/20 Rule with respect to the unit of energy property and also pays or incurs new costs for property that is an integral part of the energy property, the taxpayer may include the new costs of the integral property in the basis of the energy property for purposes of the ITC.

In a surprising development, the Proposed Regulations provide that the 80/20 Rule applies to capital improvements to a unit of energy property. Accordingly, if a taxpayer makes a capital improvement to a unit of energy property that has previously been placed in service, the taxpayer generally may not claim an ITC for its basis in the improvements unless the improvements satisfy the 80/20 Rule.

- Unfortunately, the Proposed Regulations did not address potential recapture issues. One would hope that the recapture rules would include a similar rule pursuant to which the ITC with respect to a unit of property would not be subject to recapture in a circumstance where the 80/20 rule is not satisfied.
- Note that the Proposed Regulations do not specifically address additions or modifications to integral parts of energy property.

Nameplate Capacity Used to Determine Limitations

For purposes of applying the one-megawatt exception from the PWA requirements and the five-megawatt limitation in the context of interconnection costs that qualify for ITC, the Proposed Regulations provide that the determination of whether an energy project has a maximum net output of less than 1 MW(ac) or not greater than 5 MW(ac) (as applicable), is determined based on nameplate capacity. Where applicable, taxpayers should use the ISO conditions to measure the maximum electrical generating output or usable energy capacity of an energy project.

- Examples in the Proposed Regulations clarify that the maximum electrical generating output of the property controls for purposes of the five-megawatt limitation even if the applicable interconnection agreement allows for a greater maximum output. The examples do not address how to apply the limitations in the context of an overbuild (e.g., a 5.25 MW(ac) solar facility with an interconnection agreement that limits output to 5 MW(ac)).

Summary

In general, the Proposed Regulations are a welcome development, providing helpful and actionable clarification for taxpayers on many issues, including qualified interconnection property, co-location of energy projects and qualified facilities, and the consistent application of the “single project” test. However, they include some unfortunate features as well, notably including limitations on multiple owners of energy property, a narrow concept of ITC-eligible property for RNG facilities, the inclusion of an incremental cost rule that could be difficult to apply, and a

general rule precluding the ITC for additions and modifications. In any case, the Proposed Regulations would represent the first significant update to the ITC regulations in decades and therefore must be carefully taken into account.

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