

Treasury and IRS Issue Domestic Content Guidance Under IRA

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On May 12, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued [Notice 2023-38](#), which describes certain rules that Treasury and the IRS intend to include in forthcoming proposed regulations concerning domestic content. Under the [Inflation Reduction Act of 2022](#) (IRA), projects that satisfy applicable “Buy American” requirements (the domestic content requirement) qualify for enhanced credit amounts for several clean energy tax credits, including investment tax credits under Sections 48 and 48E (ITC) and production tax credits under Sections 45 and 45Y (PTC).

The regulations will apply to taxable years ending after May 12. Taxpayers may rely on the notice with respect to the domestic content requirements for any qualified facility, energy project, or energy storage technology the construction of which begins before the date that is 90 days after the date of publication of the forthcoming proposed regulations in the *Federal Register*.

Overview

In general, the domestic content requirement applies to any steel, iron, or Manufactured Product (defined below) that is a component of an Applicable Project.

An Applicable Project is eligible for a domestic content bonus credit amount if the Applicable Project satisfies the domestic content requirement, and the taxpayer timely submits to the IRS the certification described below. An Applicable Project satisfies the domestic content requirement if the Steel or Iron Requirement and the Manufactured Products Requirement (defined below) are satisfied. For this purpose, an Applicable Project is a qualified facility for purposes of the PTC, or an energy project or qualified investment in an energy storage project for purposes of the ITC (and including investments in qualified facilities electing ITC).

Definitions

The notice defines some key concepts, which are fundamental to the domestic content requirement. Of particular note are the following definitions that describe the levels of components included in the Applicable Project for which cost information may be relevant:

“Applicable Project Component” means any article, material, or supply, whether manufactured or unmanufactured, that is directly incorporated into an Applicable Project. An Applicable Project Component may be steel, iron, or a Manufactured Product.

- Guidance cross-referenced in Section 45(b)(9) specifies that components must be “directly incorporated into the end product at the final assembly location.” The definition of Applicable Project Component leaves open the possibility that the incorporation could happen somewhere other than the project site, which could raise difficult questions of interpretation.

“Manufactured Product” means an item produced as a result of the manufacturing process.

“Manufactured Product Component” means any article, material, or supply, whether manufactured or unmanufactured, that is directly incorporated into an Applicable Project Component that is a Manufactured Product.

“U.S. Component” means a Manufactured Product Component that is (1) manufactured or produced in the United States, regardless of the origin of its subcomponents or (2) mined in the United States.

Key to many of the concepts in the notice is distinguishing between “manufacturing” and “assembly.” The notice defines a “manufacturing process” as “the application of processes to alter the form or function of materials or of elements of a product in a manner adding value and transforming those materials or elements so that they represent a new item functionally different from that which would result from mere assembly of the elements or materials.”

- There are many situations where the distinction may not be clear (e.g., custom components that require modifications to pre-manufactured subcomponents as part of the assembly process).

Steel or Iron Requirement

The domestic content requirement with respect to steel or iron (Steel or Iron Requirement) is met if, consistent with 49 CFR § 661.5(b) and (c), all manufacturing processes with respect to any steel or iron items that are Applicable Project Components take place in the United States, except metallurgical processes involving refinement of steel additives.

- It is important to note that the Steel or Iron Requirement is binary. If any steel or iron that is subject to the Steel or Iron Requirement does not satisfy the requirement, the entire Applicable Project will fail the domestic content requirement.
- It would be helpful for the proposed regulations to clarify that the raw materials, including for this purpose raw iron ore and scrap steel, need not be domestic.

The Steel or Iron Requirement applies to Applicable Project Components that are construction materials made primarily of steel or iron and are structural in function. The Steel or Iron Requirement does not apply to steel or iron used in Manufactured Product Components or subcomponents of Manufactured Product Components. For

example, items such as nuts, bolts, screws, washers, cabinets, covers, shelves, clamps, fittings, sleeves, adapters, tie wire, spacers, door hinges, and similar items, that are made primarily of steel or iron but are not structural in function are not subject to the Steel or Iron Requirement. Table 2 in Section 3.04 of the notice categorizes certain items as subject to either the Steel or Iron Requirement of Manufactured Product Requirement.

- The clarification that the Steel or Iron Requirement does not apply items unless they are “structural in function” is a welcome clarification, particularly because 49 CFR § 661.5 provided only that the “Buy American” steel or iron requirements applied to materials made primarily of steel or iron, which included, *but was not limited to*, structural steel or iron.
- Given the binary nature of the Steel or Iron Requirement, the non-exclusive lists of items that are not subject to the Steel or Iron Requirement is also welcome. Of particular note, the categorization of photovoltaic trackers as Manufactured Products appears to settle the uncertainty around torque tubes and clarify that they are subject to the Manufactured Products Requirement and not the Steel or Iron Requirement.

Manufactured Products Requirement

The Manufactured Products Requirement is met if all Applicable Project Components that are Manufactured Products are produced in the United States or are deemed to be produced in the United States. All Applicable Project Components that are Manufactured Products are deemed to be produced in the United States if the Adjusted Percentage Rule (defined below) is satisfied.

A Manufactured Product is considered to be produced in the United States (and therefore is a U.S. Manufactured Product) if: (1) all of the manufacturing processes for the Manufactured Product take place in the United States; and (2) all of the Manufactured Product Components of the Manufactured Product are U.S. Components.

- Given the prevalence of global supply chains, and the complexity of certain manufactured products, the requirement that all the Manufactured Product Components be of U.S. origin could be very difficult to meet. As explained below, the binary nature of this requirement has some counterintuitive results.
- The distinction between a Manufactured Product Component and a subcomponent is essential because the former must be manufactured in the United States but the latter need not be. However, the Notice defines Manufactured Product Component broadly and does not define subcomponents or articulate a clear basis for distinguishing between a component and a subcomponent.

Adjusted Percentage Rule

The Adjusted Percentage Rule is the most technical area of the notice. It is also the place where Treasury and the IRS have made some key policy choices that could materially affect whether an Applicable Project will meet the domestic content requirement, and if so, whether it can be demonstrated that the requirement has been met.

The Domestic Cost Percentage for an Applicable Project is equal to the percentage produced by dividing the Domestic Manufactured Products and Components Cost (defined below) by the Total Manufactured Products Cost (defined below). If the Domestic Cost Percentage for an Applicable Project equals or exceeds the adjusted percentage that applies to the Applicable Project, then the Applicable Project satisfies the Adjusted Percentage Rule. For most projects under the rules now in effect, the adjusted percentage is 40%.

The Domestic Manufactured Products and Components Cost is the sum of the costs of an Applicable Project's Applicable Project Components that are (1) U.S. Manufactured Products^[1] or (2) U.S. Components of Non-U.S. Manufactured Products^[2]. The cost of a U.S. Manufactured Product includes only direct materials and direct labor costs incurred by the U.S. Manufactured Product's manufacturer to produce the U.S. Manufactured Product. The cost of a U.S. Component of a Non-U.S. Manufactured Product includes only direct materials and direct labor costs incurred by the Non-U.S. Manufactured Product's manufacturer to produce or acquire the U.S. Component. The Domestic Manufactured Products and Components Cost does not include the direct materials or direct labor costs of the Non-U.S. Manufactured Product's manufacturer to produce the Non-U.S. Manufactured Product.

- A manufacturer's direct materials and labor costs are included in the numerator for U.S. Manufactured Products but not for a Non-U.S. Manufactured Product. This rule results in a "cliff effect" because a Manufactured Product with a single non-U.S. Component is a Non-U.S. Manufactured Product. Applying the rule literally, the direct materials and labor of a Manufactured Product with 99 U.S. Components would not be taken into account in the numerator if it had a single component made abroad even if the direct materials and labor are U.S. sourced. As a result, there appears to be no incentive for manufacturers of Non-U.S. Manufactured Products to locate manufacturing facilities in the United States. This result is hard to justify as a matter of policy.
- Presumably there will not be much if any direct labor costs to acquire a U.S. Component.
- Demonstrating compliance will require obtaining potentially sensitive cost information from both U.S. and (as noted below) non-U.S. manufacturers.
- Direct costs, including direct labor costs, of incorporating the Applicable Project Components into the Applicable Project are not counted in the Domestic Manufactured Products and Components Cost. In other words, installation costs at a project site do not count in the numerator.
- Direct costs are determined by reference to Treasury Regulation Section 263A-1(e)(2)(i) — *i.e.*, they are direct materials and direct labor costs that are paid or incurred within the meaning of Section 461 by the applicable manufacturer, and they do not include overhead costs. Accordingly, to determine the Domestic Manufactured Products and Components Cost, developers will need to obtain direct cost information from manufacturers of Manufactured Product Components (whether directly procured or procured by EPC contractors).
- Under the notice, the manufacturer of a U.S. Manufactured Product or a Non-U.S. Manufactured Product is the

person that performed the manufacturing process that produced the U.S. Manufactured Product or the Non-U.S. Manufactured Product. The rules under § 263A that are used to determine whether a taxpayer is engaged in production or resale activities for purposes of § 263A do not apply.

The Total Manufactured Products Cost for an Applicable Project is the sum of the costs of each Applicable Project Component that is a Manufactured Product. For purposes of determining the Total Manufactured Products Cost for an Applicable Project, the cost of an Applicable Project Component that is a Manufactured Product includes only direct costs as defined in Section 1.263A-1(e)(2)(i) that are paid or incurred within the meaning of Section 461 by the manufacturer of the Manufactured Product to produce the Manufactured Product.

- The focus on manufacturers' costs will make compliance significantly more difficult. Because the fraction is calculated by reference to the manufacturer's direct costs (excluding indirect costs and profit), the denominator of the fraction may be artificially inflated (by the amount of otherwise excludible indirect costs and profit) unless taxpayers can demonstrate the direct cost information from suppliers of Non-U.S. Manufactured Products. This could be challenging since such suppliers have nothing to gain from revealing their costs (whereas suppliers of U.S. Manufactured Products may negotiate a premium for their cooperation with satisfying the domestic content requirement).

Distinguishing Between Steel or Iron and Manufactured Products

Table 2 of the notice provides a safe harbor for some of the components of a utility scale solar project, land-based and offshore wind facilities, and a battery energy storage facility. With respect to a solar facility, the steel photovoltaic module tracking; piles, or ground screws; and steel or rebar in the foundation are structural and therefore must be manufactured in the U.S. The photovoltaic tracker and inverters are Manufactured Products.

With respect to modules, the photovoltaic cells, mounting frame or backrail, glass, encapsulate, backsheet, junction box (including pigtailed and connectors), edge seals, potting, adhesives, bus ribbons, and bypass diodes are all Manufactured Product Components. If any of these Manufactured Product Components are manufactured outside the U.S., the photovoltaic module will be considered to be a Non-U.S. Manufactured Component resulting in only the direct labor and material costs of the U.S. Manufactured Components to be included in the numerator of the fraction to determine the Domestic Content Percentage, whereas the entire direct materials and labor cost of the modules is included in the denominator.

- The examples in Table 2 of the notice do not make clear what other components rise to the level of an applicable project component. Noticeably missing are medium- and high-voltage transformers, which would appear to be manufactured products.

Summary of the Steps to Determine Qualification

The following provides a brief overview of the steps to determine whether an applicable project will satisfy the domestic content requirement:

1. Identify the Applicable Project Components.
2. Segregate the Applicable Project Components into (i) structural steel and iron, (ii) Manufactured Products, and (iii) everything else.
3. Confirm that all structural steel and iron has been produced in the United States.
4. Calculate the Domestic Content Percentage with respect to the Manufactured Products.
 - a. The numerator is equal to the sum of (i) the direct materials and direct labor costs of the applicable manufacturers to produce the U.S. Manufactured Products and (ii) the direct materials and direct labor costs of the applicable manufacturers to produce or acquire the U.S. Components of Non-U.S. Manufactured Products.
 - b. The denominator is equal to the aggregate direct materials and direct labor costs of the applicable manufacturers to produce all the Manufactured Products.

Certification

Project owners must submit a statement to the IRS for each Applicable Project for which they are claiming a domestic content bonus, certifying that the Steel or Iron Requirement and Manufactured Products Requirement are met (the domestic content certifying statement). The domestic content certifying statement must be attached to the owner's tax return for the first taxable year in which a domestic content bonus credit amount for an Applicable Project is claimed. For each subsequent taxable year, the owner must attach to its return a copy of the domestic content certifying statement initially submitted. Notice 2023-38 sets forth the specific information that must be included in the domestic content certifying statement, which must be signed under penalties of perjury by a person with legal authority to bind the taxpayer.

Conclusion

Notice 2023-38 sets forth a complicated test for the domestic content requirement that will be difficult for many project owners to apply, particularly given the focus of the Adjusted Percentage Rule on direct costs for Manufactured Product Components. Collection of direct cost information from all manufacturers of Manufactured Product Components (whether U.S. Components or foreign components) is not likely to be well-received by project owners, developers, or manufacturers.

[1] A "U.S. Manufactured Product" is an item produced as a result of a manufacturing process that is considered to be produced in the United States (as described above).

[2] A "Non-U.S. Manufactured Product" is an item produced as a result of a manufacturing process that is not a

U.S. Manufactured Product.

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