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Tax Update December 9, 2024

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

On December 12, 2024, the IRS and Treasury are expected to publish final regulations in the Federal Register on the investment tax credit under section 48 of the Internal Revenue Code of 1986, as amended.

On December 12, 2024, the IRS and Treasury are expected to publish final regulations (the "Final Regulations") in the Federal Register on the investment tax credit under section 48 (the "ITC").[1] Please see the unpublished version of the Final Regulations here. The Final Regulations generally adopt the proposed regulations (the "Proposed Regulations") published in November 2023 (see our earlier alert regarding the Proposed Regulations available here), but include certain modifications and clarifications.[2]

Requirements for Energy Property

Units of Energy Property

The Proposed Regulations made owning a "unit of energy property" a prerequisite to claiming the ITC.[3] The Final Regulations retain this requirement and also generally retain the definition of a "unit of energy property" as all functionally independent components of energy property that are operated together and can operate apart from other energy properties. The Final Regulations, however, include some useful adjustments, such as clarifying that the "unit of energy property" for solar property is all the solar panels connected to a common inverter.[4] The preamble to the

Final Regulations clarifies that a large, ground-mounted solar energy facility may comprise one or more "units of energy property."[5]

Retrofitted Property

Despite significant criticism by commentators, the Final Regulations adopt the rule in the Proposed Regulations providing that modifications or improvements to existing energy property are not eligible for the ITC unless the "80/20 rule" is satisfied.[6] Importantly, the 80/20 rule applies separately to each "unit of energy property."

Fractional Interest / Multiple Owners Rule

The Proposed Regulations introduced 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.

Although the IRS and Treasury received many comments criticizing the fractional interest rules in the Proposed Regulations, the Final Regulations retain those rules, with revisions to an example to make clear that a taxpayer that owns components sufficient to comprise "a unit of energy property" may claim the ITC even if another taxpayer owns certain other components of that energy property.[7]

Certain Software

The preamble to the Final Regulations explains that certain software "that optimizes and automates" section 48(a)(3) energy property may be ITC-eligible under the "integral part" eligibility framework of the Final Regulations.

Categories of Energy Property

Energy Storage Technology. The Final Regulations modify the definitions for some of the ITC-eligible energy storage technologies:

- *Hydrogen storage technology*. In response to numerous comments, the IRS and Treasury dropped the requirement of the Proposed Regulations that would have limited ITC-eligible hydrogen storage technology to technology that stores hydrogen for the production of energy.[8] The preamble to the Final Regulations, however, states that equipment used to store hydrogen carriers (including ammonia and methanol) is not ITC-eligible.[9]
- *"Second life" batteries*. The preamble to the Final Regulations makes clear that "second life" battery components are not considered new components for purposes of applying the 80/20 rule.[10]

Qualified Biogas Property. The IRS and Treasury received numerous comments regarding the definition of qualified biogas property. In response, the Final Regulations modify certain aspects of the definition, including by expressly providing that gas upgrading equipment and anaerobic digesters constitute qualified biogas property.

In addition, the Final Regulations confirm that integral parts of qualified biogas property include waste feedstock collection systems, landfill gas collection systems, and mixing and pumping equipment.[11] Moreover, under the Final Regulations, methane content is measured when the biogas exits the qualified biogas property, whereas under the Proposed Regulations methane content would have been measured at an earlier point in the production process (*i.e.*, when the gas exited the biogas production system).[12] The Final Regulations implemented this change with respect to the measurement point of methane in response to comments on the Proposed Regulations. The preamble to the Final Regulations indicates that this change places the measurement point after the gas has passed through the cleaning and conditioning and/or gas upgrading equipment and that, as a result of this change, this measurement point is more consistent with the "sale or productive use" requirement applicable to qualified biogas property under the Code.[13] The Final Regulations also permit limited flaring of gas as long as the primary purpose of the qualified biogas property is the sale or productive use of biogas and all flaring complies with relevant Federal, State, regional, Tribal, and local laws and regulations.[14]

"Energy Project" for PWA, Domestic Content, and Energy Community Rules

As background (and refresh), under the Code, bonus ITC amounts are available for projects that satisfy "domestic content" and/or "energy community" requirements (see our prior alerts on "domestic content" here and here and our prior alert on "energy community" requirements here).

To be eligible for the full base ITC and full bonus credit amounts under the Code, taxpayers must satisfy the prevailing wage and apprenticeship requirements ("PWA Requirements") (see our prior alerts here and here). Satisfaction of the PWA Requirements and qualification for the "domestic content" and "energy community" bonus credit amounts is tested, per the Code, at the level of an "energy project."

The Final Regulations maintain the bright-line rule approach of the Proposed Regulations for purposes of determining whether multiple "energy properties" constitute a single "energy project" for these purposes, with certain modifications.

The Proposed Regulations would have required that, in addition to the multiple energy properties being owned by a taxpayer (including certain related parties), at least *two* of seven enumerated factors must be present. The Final Regulations raised the threshold to require the presence of at least *four* of those factors,[15] with the result that fewer energy properties will be aggregated into a single "energy project" for purposes of the PWA requirements, the "domestic content" requirements, and the "energy community" requirements.

The Final Regulations also liberalized the time for determining whether multiple energy properties satisfy the relevant criteria. Specifically, under the Final Regulations, the taxpayer may choose to make the determination at any time during construction of the multiple energy properties or during the taxable year in which the final energy property comprising the energy project is placed in service.[16]

Commentary

- The bright-line nature of the single "energy project" rules will continue to provide helpful certainty.
- The increase in the number of single project factors that must be satisfied (from two to four), along with the added flexibility in the timing of the single project determination, will help reduce the risk that multiple energy properties might inadvertently be grouped as a single project (*e.g.*, because they were built pursuant to the same construction contract or financed pursuant to the same financing agreement).
- The new rule making certain software ITC-eligible is welcome, although the reason given for declining to extend the rule to PTC projects that elect the ITC (*i.e.*, that those projects are subject to a "tangible property" requirement) is confusing and may suggest that the same software will not be eligible under the section 48E technology-neutral investment tax credit (discussed in our previous alert available here).

[1] Unless indicated otherwise, all "section" references are references to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" are to the Treasury regulations promulgated under the Code, each as in effect as of the date of this alert.

[2] The IRS and Treasury issued corrections to the Proposed Regulations on January 12, 2024, which are available here, and on February 22, 2024, which are available here.

[3] Because the ITC-eligibility of an "integral part" or qualified interconnection property is dependent on a taxpayer also owning energy property (that independently qualifies for the ITC and that operates in connection with that integral part or qualified interconnection property), a taxpayer that only owns, and incurred costs with respect to, an integral part or qualified interconnection property (and not energy property that operates in connection with that integral part or qualified interconnection property and that separately qualifies for the ITC) is not entitled to claim any ITC in respect of that integral part or that qualified interconnection property.

[4] Treas. Reg. § 1.48-9(f)(5)(i).

[5] The Final Regulations make clear that power conditioning and transfer equipment are not part of the "unit of energy property," but that they are ITC-eligible as integral parts.

[6] Treas. Reg. §§ 1.48-14(a)(2) and 1.48-14(a)(3)(iii). Under the "80/20 rule," property generally may be treated as originally placed in service even if it contains some items of used property, but only if the fair market value of the used property is not more than 20 percent of the total value of the relevant property. Because of this low thresholder for used property, a taxpayer generally needs to undertake substantial retrofitting of energy property to meet this rule.

[7] Treas. Reg. § 1.48-14(e)(4)(ii).

[8] T.D. 10015 (2024), Preamble. The Final Regulations also clarify that hydrogen liquefaction equipment and gathering and distribution lines within a hydrogen energy storage property are property that is integral part of hydrogen energy storage property.

[9] T.D. 10015 (2024), Preamble. The preamble to the Final Regulations also references a comment requesting that the Final Regulations confirm equipment used to process hydrogen into

ammonia, methanol, and other carriers is hydrogen energy storage property, but neither the preamble nor the Final Regulations directly respond to the comment.

[10] T.D. 10015 (2024), Preamble.

[11] Treas. Reg. § 1.48-9(e)(11)(i).

[12] *Compare* Treas. Reg. § 1.48-9(e)(11)(ii) *with* Proposed Treas. Reg. § 1.48-9(e)(11)(ii).

[13] Section 48(c)(7)(A)(ii).

[14] Treas. Reg. § 1.48-9(e)(11)(iii).

[15] *Compare* Treas. Reg. § 1.48-13(d)(1) *with* Proposed Treas. Reg. § 1.48-13(d)(1).

[16] Treas. Reg. § 1.48-13(d)(2). The Preamble states that multiple energy properties comprising a single project do not need to be the same type of energy property. For example, an energy storage property and a generation property may be treated as a single energy project.

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