Locke Lord Deep Dive: Examining Proposed Regulations on Expanded ITC Under Inflation Reduction Act

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On November 22, 2023, the Internal Revenue Service ("IRS") and the U.S. Treasury Department ("Treasury") published Proposed Treasury Regulations (**REG-132569-17**) (the "Proposed Regulations") providing long-awaited guidance and amending existing regulations relating to the investment tax credit (the "ITC") under Section 48 of the Internal Revenue Code of 1986, as amended (the "Code"). The ITC provides a tax credit for investments in energy producing property. The Inflation Reduction Act of 2022 (the "IRA") significantly expanded the types of projects that may qualify for the ITC, and as explained in **our original QuickStudy on the Proposed Regulations**, the Proposed Regulations seek to provide clarity and certainty regarding eligibility for the ITC to facilitate investment decisions for clean energy projects. The Proposed Regulations also serve to withdraw and repropose portions of other previously proposed regulations published on August 30, 2023 regarding the ITC (**REG-100908-23**) and supplement additional proposed regulations published on June 21, 2023 regarding the transferability of credits under Section 6418 of the Code (**REG-101610-23**).

This Deep Dive is intended to provide additional detail on guidance within the Proposed Regulations with respect to a number of key topics, including: (i) the determination of functional interdependence and integral parts, (ii) treatment of energy property with multiple owners, (iii) placed in service requirements, (iv) the "80/20 Rule" for retrofitted energy property, (v) dual use property, (vi) energy property, (vii) expansion of the definitions of energy property, and (viii) the prevailing wage and apprenticeship requirements.

A. Background

The ITC provides a tax credit equal to the "energy percentage" of the eligible basis of energy property placed in service during a taxable year. This energy percentage is generally a base rate of 6%; however, the rate is increased to 30% for projects that have a maximum net output of less than 1 megawatt or satisfy certain prevailing wage and apprenticeship ("PWA") requirements. Additional bonus credit amounts are available for projects that satisfy certain domestic content requirements (up to 10%), projects that are built in energy communities (up to 10%), and projects that are located in low-income communities (up to 20%).

The ITC strongly incentivizes investment in clean energy projects. However, the current Treasury Regulations promulgated under Section 48 of the Code have not been updated for many years, leading to questions of ITC eligibility for renewable energy projects utilizing advancements in technology over the last several decades. The Proposed Regulations provide essential updates reflecting such new technologies and classes of ITC-eligible equipment following the IRA. This crucial guidance should bring clarity and certainty to taxpayers in facilitating investment decisions for clean energy projects.

B. Scope of Energy Property

1. *Functional Interdependence and Integral Parts*

The ITC is available only for "energy property." In addressing the scope of such energy property, the Proposed Regulations would adopt an approach intended to provide a technology-neutral method for determining what is considered included in the energy property that is broad enough to encompass technological changes. Accordingly, the Proposed Regulations

would provide that energy property includes a "unit of energy property." The term "unit of energy property" means 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. As an example, for rooftop solar energy property, all components of property that are installed on a single rooftop are considered a single unit of energy property. Furthermore, property that is an integral part of an energy property is treated as energy property.

For these purposes, the Proposed Regulations would provide that the term "functionally interdependent" generally means that 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***. However, 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, "functionally interdependent" would mean that 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 would further provide that any property owned by a taxpayer is considered an "integral part" of 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 the intended function. The Proposed Regulations provide examples of property that would constitute integral parts of energy property, including power conditioning equipment, transfer equipment, onsite roads used for equipment to operate and maintain the energy property, structures that are essentially an item of machinery or equipment, and a structure that houses property that is integral to the activity of an energy property if the use of the structure is so closely related to the use of the housed energy property that the structure clearly can be expected to be replaced when the energy property it initially houses is replaced.

Any property that meets the "functionally interdependent" and "integral part" requirements above is part of an energy property regardless of where such property is located.

Importantly, the Proposed Regulations would provide an example regarding an offshore wind facility. This example would clarify that all components of the offshore wind facility, up to and including the transformer and switchgear housed in the onshore substation, are either functionally interdependent components of an energy property or integral parts of an energy property, and thus would be included in the basis of the offshore wind facility for purposes of computing the ITC.

2. *Energy Property with Multiple Owners*

The preamble to the Proposed Regulations notes that many commenters requested that the regulations address situations involving energy property with multiple owners, such as solar condos and community solar facilities. In answering these requests, the Treasury and IRS determined that a taxpayer who owns an energy property is eligible for the ITC only to the extent of the taxpayer's eligible basis in the energy property. In the case of multiple parties holding ownership shares in an energy property, the Proposed Regulations would provide that each party is eligible for the ITC to the extent of the party's fractional ownership interest.

More specifically, Proposed Regulation Section 1.48-14(e)(4) requires that a taxpayer must directly 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. However, the Proposed Regulations further provide that the use of property owned by one taxpayer that is an integral part of an energy property owned by a second taxpayer will not prevent an ITC from being determined with respect to the second taxpayer's energy property.

The Proposed Regulations would provide an example clarifying the treatment of such multi-owner energy property as follows:

> X owns a wind energy property that is a unit of energy property and property that is an integral part of the wind energy property, specifically a transformer where the electricity is stepped up to electrical grid voltage before being transmitted to the electrical grid through an intertie. Y owns a solar energy property that is a unit of energy property that connects to X's transformer. Because Y does not hold an ownership interest in the transformer, Y may compute its section 48 credit for its solar energy property but it will not include any costs relating to the transformer.

However, when multiple taxpayers share ownership of property that is an integral part of separate energy properties, the Proposed Regulations grant ITC eligibility to both taxpayers. The Proposed Regulations would provide an additional example for this scenario as follows:

> X owns a wind energy property that is a unit of energy property and Y owns a solar energy property that is a unit of energy property that are co-located. Both X's wind energy property and Y's solar energy property connect to a substation that houses a step-up transformer where the electricity is stepped up to electrical grid voltage before being transmitted to the electrical grid through an intertie. X and Y each own a 50% fractional ownership interest in the step-up transformer. The step-up transformer is an integral part of both the wind energy property and the solar energy property (as defined in Proposed Regulation Section 1.48–9(f)(3)(i)). As a result, X and Y may both compute a Section 48 credit for their respective energy properties by including 50% of the costs of the step-up transformer.

3. *Placed in Service*

Energy property must be placed in service during the taxable year to be eligible for the ITC. Typically, energy property is considered placed in service in the earlier of (1) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such energy property begins, or (2) the taxable year in which the energy property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business or in the production of income. In clarifying this requirement, the Proposed Regulations would largely adopt these traditional rules for determining whether a taxpayer has placed an energy property in service, while adding certain modifications to those rules.

The Proposed Regulations would further clarify that energy property "in a condition or state of readiness and availability for a specifically assigned function" includes, but is not limited to, components that are acquired and set aside during the taxable year for use as replacements for a particular energy property (or energy properties) in order to avoid operational time loss and equipment that is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects. Alternatively, the Proposed Regulations would provide that components acquired to be used in the construction of an energy property will not be considered "in a condition or state of readiness and availability for a specifically assigned function."

4. *Retrofitted Property and the "80/20 Rule"*

The Treasury and IRS have previously published guidance providing that a qualified facility may qualify as originally placed in service even though it contains some used or retrofitted property, provided the fair market value of the used property is not more than 20 percent of the qualified facility's total value (the "80/20 Rule"). The Proposed Regulations would adopt the 80/20 Rule, thereby applying the rule to energy property for purposes of the ITC. Under the Proposed Regulations, this 80/20 Rule would be applied separately to each unit of energy property that is part of an energy project.

5. *Dual Use Property*

Energy property often uses energy derived from both a qualifying source for ITC purposes and from a nonqualifying source ("Dual Use Property"). For this reason, the existing Treasury Regulations under Section 48 of the Code provide a rule for pro-rating ITC eligible basis of Dual Use Property. Under this rule, certain Dual Use Property is eligible for the ITC to the extent of the property's basis or cost allocable to its annual use of energy from a qualified source, provided the use of energy from "non-qualifying" sources does not exceed 25% of the total energy input of the property during the annual measuring period (the "Dual Use Rule").

In other words, the existing regulations require that energy property must use a minimum of 75% of energy from a qualified source during an annual measuring period to qualify for the ITC (commonly known as the "75% Cliff"). Further, if the energy property uses between 75% and 100% of energy from a qualifying source, only a proportionate amount of the eligible basis of the energy property is taken into account in computing the ITC. Alternatively, if less than 75% of the energy used is from qualifying sources, then the eligible basis is zero, and the property is not eligible for the ITC. Notably, for purposes of these calculations, the existing regulations preclude an energy property from receiving and aggregating energy from a combination of qualifying sources.

The Proposed Regulations would adopt the Dual Use Rule while making several modifications to its functionality. Most importantly, the Proposed Regulations would reduce the 75% Cliff to a 50% Cliff, thereby providing that Dual

Use Property will qualify as energy property if its use of energy from non-qualifying sources does not exceed 50% of its total energy input. For application of this 50% Cliff, the Proposed Regulations would otherwise follow the existing regulations, providing that (1) if the energy used from qualifying sources is between 50% and 100%, only a proportionate amount of the eligible basis of the energy property will be taken into account in computing the amount of the ITC, and (2) if the energy used from qualifying sources is less than 50%, then the eligible basis is zero, and the property is not eligible for the ITC.

Importantly, for purposes of these calculations, the Proposed Regulations also revise the Dual Use Rule to permit the aggregation of energy inputs from a combination of qualifying sources. However, the Proposed Regulations will require recapture of the ITC if the equipment's use of energy from all qualifying sources is reduced below 50% of its total energy input.

The preamble to the Proposed Regulations also confirms that the Dual Use Rule is no longer relevant to determining the eligibility of energy storage technology because the IRA added energy storage technology as an energy property effective for property placed in service after 2022.

6. *Types of Energy Property*

To qualify for the ITC, property must fall under the definition of energy property. Proposed Regulation Section 1.48-9(e) would expand upon the definitions of energy property provided in existing Treasury Regulation Section 1.48-9 to account for new technologies that were added by the IRA. Specifically, the Proposed Regulations detail fourteen types of energy property that are eligible for the ITC, which are discussed in detail below.

i. Solar Energy Property

Adopting the statutory language in Section 48(a)(3)(A)(i) of the Code, the Proposed Regulations define solar energy property as equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool. However, the Proposed Regulations expand upon the statutory language by including in solar energy property (i) solar electric generation equipment, which is defined as equipment that converts sunlight into electricity through the use of devices such as solar cells or other collectors, (ii) solar process heat equipment, which is defined as equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processes, and (iii) any other equipment that uses solar energy to heat or cool a structure or provide hot water for use in a structure. Solar energy property under the Proposed Regulations also includes all parts related to the functioning of the equipment described above. The modified definition of Solar energy property also eliminates the exclusion for passive Solar energy property under the current regulations because Section 48 of the Code does not distinguish between passive and active solar energy systems.

ii. Fiber-Optic Solar Energy Property

The Proposed Regulations would adopt the statutory definition of fiber-optic solar energy property, defining such property as equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight.

iii. Electrochromic Glass Property

The Proposed Regulations would adopt the statutory definition electrochromic glass property, which defines such energy property as equipment that uses electricity to change its light transmittance properties in order to heat or cool a structure, but clarifies that light transmittance properties include both visible light and near infrared light. The Proposed Regulations would further clarify that there are only two types of electrochromic glass property: (1) electrochromic glass incorporated into a full window that is installed directly into a building, and (2) electrochromic glass incorporated into a secondary window (known as secondary glazing) that is installed on top of an existing window. Further, the Proposed Regulations would provide that electrochromic glass property includes windows, including secondary windows (also referred to as secondary glazings), that incorporate electrochromic glass. The preamble to the Proposed regulations suggests that this also includes the full controls package, the electrochromic glass coating, and the balance of windows and installation components including glass, flashing, framing, and sealants.

Additionally, to ensure the intended energy savings occurs from the installation of Electrochromic Glass Property, the Proposed Regulations would require that electrochromic windows must be rated in accordance with the

National Fenestration Rating Council and secondary glazing systems must be rated in accordance with the Attachments Energy Rating Council Rating and Certification Process, or subsequent revisions.

iv. Geothermal Energy Property

The Proposed Regulations would adopt the existing definitional framework with respect to geothermal energy property by defining such property as equipment used to produce, distribute, or use energy derived from a geothermal deposit, but only in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission stage. The definition of geothermal energy property included in the Proposed Regulations would also retain the inclusion of production equipment and distribution equipment by adopting modified definitions of each such type of equipment.

The Proposed Regulations would define production equipment as equipment necessary to bring geothermal energy from the subterranean deposit to the surface, including well-head and downhole equipment (such as screening or slotting liners, tubing, downhole pumps, and associated equipment). This definition would specifically include production, injection, and monitoring wells required for production of the geothermal deposit as production equipment; however, the definition would not include equipment used for exploration and development of geothermal deposits. Finally, the Proposed Regulations would provide that if geothermal energy is used to generate electricity, production equipment would include the property necessary to produce electricity.

The Proposed Regulations would define distribution equipment as equipment that transports geothermal energy from a geothermal deposit to the site of ultimate use. This definition would specifically include components of a building's heating and/or cooling system, such as pipes and ductwork that distribute within a building the energy derived from the geothermal deposit. Further, the Proposed Regulations provide that if geothermal energy is used to generate electricity, distribution equipment would include equipment that transports geothermal fluids between the geothermal deposit and the power plant.

v. Qualified Fuel Cell Property

The Proposed Regulations would adopt the statutory definition of qualified fuel cell property, thereby defining such property as a fuel cell power plant that has a nameplate capacity of at least 0.5 kilowatts (1 kilowatt in the case of a fuel cell power plant with a linear generator assembly) of electricity using an electrochemical or electromechanical process, and an electricity-only generation efficiency greater than 30%. For this purpose, the Proposed Regulations provide that electricity-only generation efficiency may be calculated by dividing the heat rate of the fuel cell by the higher heating value of the fuel.

The Proposed Regulations largely adopt the statutory definition of a fuel cell power plant as an integrated system comprised of a fuel cell stack assembly, or linear generator assembly (not including any assembly that contains rotating parts), and associated balance of plant components that converts a fuel into electricity using electrochemical or electromechanical means.

vi. Qualified Microturbine Property

The Proposed Regulations would adopt the statutory definition of qualified microturbine property, thereby defining such property as a stationary microturbine power plant that has a nameplate capacity of less than 2,000 kilowatts and an electricity-only generation efficiency of not less than 26% at International Standard Organization conditions. The Proposed Regulations would further follow Section 48 of the Code in (1) defining a stationary microturbine power plant as an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy, and (2) providing that a stationary microturbine power plant includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency, and power factors.

vii. Combined Heat and Power System Property

The Proposed Regulations would simplify the statutory definition of combined heat and power system property ("CHP Property"), defining such property as property comprising a system that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications). The Proposed Regulations would also follow Section 48 of the Code in requiring that (1) CHP property must produce at least 20% of its total useful energy in the form of thermal energy that is not used

to produce electrical or mechanical power (or combination thereof), and at least 20% of its total useful energy in the form of electrical or mechanical power (or combination thereof), and (2) the energy efficiency percentage of CHP property must exceed 60% (except in the case of CHP systems that use biomass within the meaning of Section 45 of the Code).

As in Section 48 of the Code, the Proposed Regulations would explicitly exclude from the definition of CHP Property (i) any property comprising a system if such system has a capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower or an equivalent combination of electrical and mechanical energy capacities and (ii) property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

viii. Qualified Small Wind Energy Property

The Proposed Regulations would adopt the statutory definition of qualified small wind energy property, thereby defining such property as property that uses a qualifying small wind turbine to generate electricity. The Proposed Regulations would also follow Section 48 of the Code in providing that a qualifying small wind turbine means a wind turbine that has a nameplate capacity of not more than 100 kilowatts.

The Proposed Regulations would add a requirement that small wind energy property must meet the performance and quality standards in effect at the time of acquisition of the small wind turbine set forth in the American Wind Energy Association Small Wind Turbine Performance and Safety Standard 9.1-2009, or subsequent revisions; International Electrotechnical Commission 61400-1, 61400-2, 61400-11, 61400-12, or subsequent revisions; or the ANSI/ACP 101-1-2021, the Small Wind Turbine Standard, or subsequent revisions.

ix. Geothermal Heat Pump Equipment

The Proposed Regulations would slightly modify the statutory definition of geothermal heat pump equipment, defining such property as equipment that uses the ground, ground water, or other underground fluids as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, but clarifying that in addition to the ground and ground water, other underground working fluids may be used as a thermal energy source or as a thermal energy sink.

The preamble to the Proposed Regulations additionally provides that although Section 48 of the Code does not specify energy distribution equipment and components of a building's heating and/or cooling system as components of geothermal heat pump equipment, such equipment may be integral to the function of the geothermal heat pump equipment, to heat or cool a structure. Accordingly, energy distribution equipment may be considered geothermal heat pump equipment.

x. Waste Energy Recovery Property

The Proposed Regulations would adopt the statutory definition of waste energy recovery property ("WERP"), thereby defining such property as property that generates electricity solely from heat from buildings or equipment if the primary purpose of such building or equipment is not the generation of electricity. The Proposed Regulations provide examples of buildings or equipment the primary purpose of which is not the generation of electricity including, but not limited to, manufacturing plants, medical care facilities, facilities on college campuses, pipeline compressor stations, and associated equipment.

Similar to Section 48 of the Code, the Proposed Regulations would specifically exclude from the definition of WERP any property that has a capacity in excess of 50 megawatts. Additionally, the Proposed Regulations would provide that any WERP that is part of a system that is a CHP property is not treated as WERP for purposes of Section 48 of the Code unless the taxpayer elects to not treat such system as a CHP property for purposes of Section 48 of the Code.

xi. Energy Storage Technology

The IRA amended Section 48 of the Code to add Energy Storage Technology to the definition of energy property. The Proposed Regulations would largely adopt the current statutory definition of energy storage technology, but would provide helpful clarifications and examples with respect to (1) electrical energy storage property, (2) thermal energy storage property, and (3) hydrogen energy storage property.

Note that the Proposed Regulations provide additional guidance regarding energy storage technologies that are co-located with qualified facilities eligible for the credit under Section 45 of the Code, which is discussed in more detail in Subsection 8 below.

a. Electrical Energy Storage Property

Adopting the statutory language, the Proposed Regulations would define electrical energy storage property as property (other than property primarily used in the transportation of goods or individuals and not for the production of electricity) that receives, stores, and delivers energy for conversion to electricity, and has a nameplate capacity of not less than 5 kilowatt hours. As examples, the Proposed Regulations provide that, subject to the exclusion for property primarily used in the transportation of goods or individuals, electrical energy storage property includes but is not limited to 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.

The preamble to the Proposed Regulations also provides that rechargeable electrochemical batteries of all types meet the functional interdependence definition for energy storage technology by receiving energy in the form of electricity, storing electro-chemical energy, and producing electricity.

b. Thermal Energy Storage Property

As in Section 48 of the Code, the Proposed Regulations would define thermal energy storage property as property comprising a system that is directly connected to a heating, ventilation, or air conditioning (HVAC) system; removes heat from, or adds heat to, a storage medium for subsequent use; and provides energy for the heating or cooling of the interior of a residential or commercial building, but excluding swimming pools, CHP property, and buildings and their structural components. The Proposed Regulations would further provide that thermal energy storage property includes equipment and materials, and parts related to the functioning of such equipment, to store thermal energy for later use to heat or cool, or to provide hot water for use in heating a residential or commercial building.

As examples, the Proposed Regulations provide that thermal energy storage property includes, but is not limited to, thermal ice storage systems that use electricity to run a refrigeration cycle to produce ice that is later connected to the HVAC system as an exchange medium for air conditioning the building, heat pump systems that store thermal energy in an underground tank or borehole field to be extracted for later use for heating and/or cooling, and electric furnaces that use electricity to heat bricks to high temperatures and later use this stored energy to heat a building through the HVAC system.

c. Hydrogen Storage Energy Property

Finally, the Proposed Regulations would clarify the inclusion of hydrogen energy storage property as energy storage technology by defining such property as property (other than property primarily used in the transportation of goods or individuals and not for the production of electricity) that stores hydrogen and has a nameplate capacity of not less than 5 kilowatt hours, equivalent to 0.127 kilograms of hydrogen or 52.7 standard cubic feet of hydrogen. The Proposed Regulations further provide that hydrogen energy storage property must store hydrogen that is solely used as energy and not for other purposes such as for the production of end products such as fertilizer. However, the type of hydrogen storage medium (for example, physical based or material based) is not limited under the Proposed Regulations

As examples, the Proposed Regulations provide that hydrogen energy storage property includes, but is not limited to, a hydrogen compressor and associated storage tank and an underground storage facility and associated compressors.

d. Modifications of Energy Storage Technology

As in Section 48 of the Code, the Proposed Regulations provide that energy storage technology includes energy storage technology placed in service after December 31, 2022 that either (i) was placed in service before August 16, 2022, and would be considered electrical energy storage property and hydrogen energy storage property, except that such property had a capacity of less than 5 kWh and is modified in a manner that such property (after such modification) has a nameplate capacity (after such modification) of not less than 5 kWh; or (ii) is electrical energy storage property and hydrogen energy storage property and is modified in a manner that such property (after such modification) has an increase in nameplate capacity of not less than 5 kWh, except that the basis of any existing property prior to such modification is not taken into account.

xii. Qualified Biogas Property

The IRA amended Section 48 of the Code to add qualified biogas property to the definition of energy property, and the Proposed Regulations would adopt the statutory definition of qualified biogas property. Accordingly, the Proposed Regulations would define qualified biogas property as property comprising a system that converts biomass into a gas that consists of not less than 52% methane by volume, or is concentrated by such system into a gas that consists of not less than 52% methane, and captures such gas for sale or productive use and not for disposal via combustion. As in Section 48 of the Code, the Proposed Regulations would also include within the definition of qualified biogas property any property that is part of such system that cleans or conditions such gas.

As examples, the Proposed Regulations provide that qualified biogas property includes, but is not limited to, a waste feedstock collection system, a landfill gas collection system, mixing or pumping equipment, and an anaerobic digester. However, the Proposed Regulations further state that gas upgrading equipment necessary to concentrate the gas into the appropriate mixture for injection into a pipeline through removal of other gases such as carbon dioxide, nitrogen, or oxygen is not included in qualified biogas property.

The Proposed Regulations would clarify that the methane content requirements discussed above are measured at the point at which gas exits the biogas production system (which may include an anerobic digester, landfill gas collection system, or thermal gasification equipment) because this is the point at which a taxpayer generally must determine whether it will convert the biogas to fuel for sale or use it directly to generate heat or to fuel an electricity generation unit.

xiii. Microgrid Controllers

The IRA amended Section 48 of the Code to add microgrid controllers to the definition of energy property, and the Proposed Regulations would adopt the statutory definition of microgrid controllers. Accordingly, the Proposed Regulations would define microgrid controllers as equipment that is part of a qualified microgrid and is designed and used to monitor and control the energy resources and loads on such microgrid. Further, the Proposed Regulations would define such a qualified microgrid as an electrical system that includes equipment that is capable of generating not less than 4 kilowatts and not greater than 20 megawatts of electricity; is capable of operating in connection with the electrical grid and as a single controllable entity with respect to such electrical grid, and independently (and disconnected) from such electrical grid; and is not part of a bulk-power system. The Proposed Regulations would also clarify that a qualified microgrid includes an electrical system that is capable of operating in connection with the larger electrical grid, regardless of whether a connection to the larger electrical grid exists.

xiv. Other Property Included in Section 48 of the Code

Because future legislation may add additional types of energy property to Section 48 of the Code, the Proposed Regulations provide that any other property specified by Section 48 of the Code as energy property will be treated as energy property for purposes of the Proposed Regulations.

7. Property Excluded from Energy Property

Section 48 of the Code provides that energy property shall not include any property which is part of a qualified facility the production from which is allowed as a credit under Section 45 of the Code for the taxable year or any prior taxable year.

The Treasury and the IRS acknowledge in the preamble to the Proposed Regulations that energy storage technologies eligible for the ITC are often co-located with qualified facilities eligible for the credit under Section 45 of the Code and may share power conditioning and transfer equipment. Therefore, the Proposed Regulations provide that power condition and transfer equipment that is shared by a qualified facility and an energy property may be treated as an integral part of the energy property for purposes of Section 48 of the Code. Such shared property is not considered part of a qualified facility and, therefore, the sharing of such property will not impact the ability of a taxpayer to claim the ITC for the energy property or the credit under Section 45 of the Code for the qualified facility.

8. Qualified Investment Credit Facility

Section 48 of the Code provides that a taxpayer can make an irrevocable election to treat certain types of qualified facilities (as defined in Section 45(d) of the Code), referred to as a "qualified investment credit facility," as energy property for purposes of Section 48 of the Code. Qualified facilities for which a taxpayer is eligible to make an

election include wind, closed- and open-loop biomass, geothermal, solar, landfill gas, trash, hydropower, marine and hydrokinetic facilities. However, no Section 45 credit is allowed for any taxable year with respect to any qualified investment credit facility. The Proposed Regulations would provide that the requirements of Section 45 of the Code that may apply to qualified facilities eligible to claim a credit under that Section (such as the sale of electricity to an unrelated person) are not imposed on a qualified investment credit facility that elects to claim the ITC in lieu of the credit under Section 45 of the Code.

9. Qualified Interconnection Property

The Proposed Regulations would also provide that energy property includes amounts paid or incurred by the taxpayer for qualified interconnection property in connection with the installation of energy property that has a maximum net output of not greater than 5 megawatts. For these purposes, the Proposed Regulations require that the qualified interconnection property must provide for the transmission or distribution of the electricity produced or stored by such energy property and must be properly chargeable to the capital account of the taxpayer.

Under the Proposed Regulations, qualified interconnection property means, with respect to an energy project that is not a microgrid controller, 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 at which the energy project interconnects to such transmission or distribution system in order to accommodate such interconnection; 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 the original use of which, pursuant to an interconnection agreement, commences with a utility.

For these purposes, an interconnection agreement is an agreement with a utility for the purposes of interconnecting the energy property owned by such taxpayer to the transmission or distribution system of the utility. Further, the term "utility" means the owner or operator of an electrical transmission or distribution system that is subject to the regulatory authority of a State or political subdivision thereof, any agency or instrumentality of the United States, a public service or public utility commission or other similar body of any State or political subdivision thereof, or the governing or ratemaking body of an electric cooperative.

However, the Proposed Regulations clarify that qualified interconnection property is not itself energy property. Accordingly, the Proposed Regulations further clarify that qualified interconnection property is not taken into account in determining whether an energy property satisfies the requirements for the domestic content bonus credit amount or the increase in credit rate for energy communities.

C. Prevailing Wage and Apprenticeship Rules

Code Section 48 provides that the base credit amount for the ITC is increased to 30% for satisfying the PWA requirements. To provide guidance concerning these changes, the Treasury and the IRS issued Proposed Regulation Section 1.48-13 in August 2023. The Proposed Regulations withdraw those previously proposed regulations and propose new Proposed Regulation Section 1.48-13. These newly Proposed Regulations largely encompass the previously proposed rules with minor changes and additional rules. In particular, the Proposed Regulations (1) provide the definition of an energy project for purposes of the PWA requirements, (2) clarify the recapture rules relating to the PWA requirements, and (3) clarify the statutory exception for smaller energy projects with a maximum output of less than 1 megawatt.

1. Definition of Energy Project

Under Section 48 of the Code, as amended by the IRA, the PWA requirements (as well as the domestic content bonus credit, the energy community bonus credit, and the 1 megawatt exception) apply to an "energy project." Section 48(a)(9)(ii) of the Code defines such an energy project as a project consisting of one or more energy properties that are part of a single project. The Proposed Regulations clarify this definition by stating 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 and any two or more of the following factors are present:

(i) The energy properties are constructed on contiguous pieces of land;

(ii) The energy properties are described in a common power purchase, thermal energy, or other off-take agreement or agreements;

(iii) The energy properties have a common intertie;

(iv) The energy properties share a common substation, or thermal energy off-take point;

(v) The energy properties are described in one or more common environmental or other regulatory permits;

(vi) The energy properties are constructed pursuant to a single master construction contract; or

(vii) The construction of the energy properties are financed pursuant to the same loan agreement.

The Proposed Regulations further provide that if multiple energy properties are treated as a single energy project for beginning of construction purposes with respect to the ITC, the multiple energy properties will also be treated as a single energy project for purposes of the PWA requirements, the domestic content bonus credit amount, and the increase in the ITC credit rate for energy communities.

2. *Recapture*

The Proposed Regulations provide that the increased credit amount available for satisfying the PWA requirements is subject to recapture for any project that does not satisfy prevailing wage requirements for any period with respect to an alteration or repair of such project during the five-year period beginning on the date such project is originally placed in service. Additionally, the Proposed Regulations would provide that a failure to satisfy the prevailing wage requirements with respect to any period during the five-year recapture period remains subject to correction and penalty provisions. The Proposed Regulations further clarify that (1) the five-year recapture period would begin on the day an energy project is placed in service and end on the day that is five full years after the placed-in-service date, and (2) each 365-day period (366-day period in case of a leap year) within the five-year recapture period is a separate recapture year for recapture purposes.

Notably, neither the Proposed Regulations nor Section 48 of the Code indicate that the apprenticeship requirements must be met during such five-year period.

In addition to general reporting and recordkeeping requirements, the Proposed Regulations would provide that a taxpayer who has claimed an increased ITC for complying with the PWA requirements or transferred a specified credit portion under Section 6418 of the Code that includes an increased ITC is required to provide to the IRS information on the payment of prevailing wages with respect to any alteration or repair of the project during the recapture period at the time and in the form and manner prescribed in IRS forms or instructions or in publications or guidance published in the Internal Revenue Bulletin. The preamble to the Proposed Regulations states that the IRS anticipates this annual compliance reporting obligation will be made at the time the taxpayer files its income tax or other annual return following the close of each recapture year.

3. *One-Megawatt Exception*

Section 48 of the Code and Section 1.48-13 of the Treasury Regulations proposed in August 2023 would provide that the increased ITC amount for satisfying the PWA requirements is also available with respect to energy projects with a maximum net output of less than 1 megawatt of electrical or thermal energy. However, the August proposed regulations fail to address how to determine the maximum net output of a project.

Accordingly, the Proposed Regulations clarify that the determination of whether an energy project has a maximum net output of less than 1 MW of electrical (as measured in alternating current) or thermal energy is determined based on the project's nameplate capacity. However, the Proposed Regulations would further clarify that the 1-megawatt exception is unavailable to energy properties that do not generate electricity or thermal energy, such as Electrochromic Glass Property, Fiber-Optic Solar energy property, and Microgrid Controllers.

D. Conclusion

The ITC, as expanded by the IRA, provides a major incentive for taxpayers investing in renewable energy projects. These new Proposed Regulations provide crucial guidance, essential updates, and much-needed certainty regarding eligibility for the ITC to facilitate investment decisions in such clean energy projects.

For questions regarding the IRA, the ITC, the Proposed Regulations, or to discuss the energy communities issues further, please contact one of the authors or any member of Locke Lord's tax or renewable energy teams.