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Client Alert Commentary

Latham & Watkins Transactional Tax Practice

December 16, 2024 | Number 3316

IRS Finalizes Investment Tax Credit Regulations

The regulations provide important clarity around investment tax credits for biogas property, energy storage, and interconnection costs, and ease proposed aggregation rules for multiple properties.

The Internal Revenue Service (IRS) and US Department of the Treasury (Treasury Department) issued regulations on the investment tax credit (ITC) rules that were finalized on December 12, 2024 (final regulations).

These regulations largely follow the rules that were proposed in November 2023 (proposed regulations), but with a number of important and taxpayer-friendly changes in response to over 300 comments received from industry participants.

The regulations cover a wide range of clean energy technologies, including solar, storage, biogas, combined heat and power, and hydrogen. The final regulations largely follow the same function-oriented approach, proposed in November 2023, under which all interdependent and integral components of an energy project would become eligible for the investment tax credit, with a limited number of critical clarifications.

The final regulations provide more latitude for certain biogas and hydrogen projects to qualify for tax credits, and also clarify when project interconnection costs will be eligible for tax credits. Additionally, the new rules ease aggregation concepts from the proposed rules that make it easier for projects to satisfy the prevailing wage rules, which are necessary to qualify for the full credit value, and ease the requirements for projects to obtain bonus credits under the energy community and domestic content rules in the Inflation Reduction Act (IRA). These regulations should remain relevant for a number of years as the current ITC applies to all projects that start construction before the end of 2024, and therefore these regulations will apply to most existing project pipelines.

ITC for Biogas

The final regulations make several important clarifications with respect to the ITC for qualified biogas property. When originally released, the proposed regulations excluded upgrading equipment from the ITC for qualified biogas property. The original proposals thus excluded certain types of biogas producers altogether from the ITC. The IRS and Treasury Department subsequently released an update intended to clarify that gas upgrading equipment becomes eligible for ITC by terming it “integral” to the production of biogas. The final regulations take a different approach, clarifying that gas upgrading equipment is itself considered qualified biogas equipment. This update should permit an ITC on upgrading equipment even if no other equipment is being simultaneously placed in service.

The final regulations also ease a significant issue for biogas systems processing landfill gas. Taxpayers owning biogas systems that process landfill gas often do not own the collection systems, which are typically owned by the landfill. The final regulations make this property "integral," which eases the ability of these projects to satisfy the requirement that the ITC claimant must own at least a fractional interest in the collection system.

The final regulations clarify that necessary flaring of biogas will not disqualify a biogas project from taking ITCs if the primary purpose of the equipment is the production of biogas for sale or productive use. Since many facilities may be required to flare gas from time to time, this exception comes as a welcome relief.

ITC for Energy Storage

A project can generally claim the ITC if its energy storage property is either an electrical storage property, thermal storage property, or hydrogen storage property. The final regulations contain several important clarifications regarding thermal storage property and hydrogen storage property.

The final regulations clarify several aspects of the scope of thermal storage property and include detailed descriptions of the types of property that meet this scope, as well as adopting a safe harbor that provides that any medium in which heat can be added or removed and that can heat or cool a building for at least one hour will be deemed to have met the definition of thermal storage property.

The final regulations also make two important clarifications regarding hydrogen storage property. First, these regulations remove the requirement that the hydrogen be stored exclusively for energy. Second, these regulations provide that some key equipment, including liquefaction equipment and gathering and distribution lines, can qualify for investment tax credits.

Aggregation Rules

The final regulations significantly relax the rules for combining multiple energy properties into a single "energy project" when applying the prevailing wage, domestic content, and energy community adder provisions in the IRA.

To qualify for increased tax credits, an energy project must satisfy or be exempt from the prevailing wage rules. Projects with a maximum net output of less than one megawatt are generally exempt from the prevailing wage requirements. Similarly, certain projects may qualify for increased tax credits if they are located in an energy community or if they use a minimum percentage of domestic components and US manufactured steel and iron. (For more information, see our Client Alerts IRS Issues Initial Rules for Domestic Content Bonus Tax Credits and IRS Safe Harbor Eases Path for Domestic Content Bonus Tax Credits.)

The proposed regulations defined the term "energy project" with reference to a list of seven factors that indicate whether or not multiple units of energy property are in fact one "project" for purposes of applying the prevailing wage, energy community, and domestic content rules. These factors were the same ones used by the IRS in its begun construction guidance that has been issued in a series of notices since 2013. The proposed regulations state that an energy project means any group of projects that are owned by the same taxpayer at any point during the construction of the projects and that satisfy two or more of the seven factors.

This proposed rule attracted heavy commentary, led to bizarre results in which multiple projects with little commonality were grouped together when applying the prevailing wage, domestic content, and energy community rules, and created significant uncertainty and difficulty in applying these concepts.

In a nod to those comments, the final regulations make two key changes to the proposed rules. First, projects will be grouped together only if they satisfy four of the seven factors, which helps to avoid grouping and enables taxpayers to more easily apply the rules on a project-by-project basis. Second, the final regulations allow the taxpayer to choose when to test whether to group together multiple projects. Taxpayers can now choose to test for grouping either at any point during the construction of the projects or when the last project is placed into service for tax purposes.

ITC for Interconnection Costs

One of the more significant questions in the market since the release of the proposed regulations had been how to determine whether a project qualifies for the ITC for interconnection costs, and if so, how the ITC should be calculated.

The IRA revised the ITC rules to provide that amounts paid or incurred by a taxpayer for “qualified interconnection property” (e.g., transmission upgrades) in connection with the installation of an ITC-eligible system with a maximum net output of 5 megawatts (MW) or less are themselves ITC-eligible costs. As enacted, the proposed regulations were unclear on how the 5 MW limitation should be measured in the context of a large project with individual units that could function in multiple pieces below 5 MW pieces if broken apart.

The proposed regulations took the position that the 5 MW limitation was tested at the energy property — rather than energy project — level. To use a solar project as an example, this rule suggested that taxpayers would look to the nameplate capacity of each individual inverter, notwithstanding that the aggregate nameplate capacity of multiple inverters operating as a single project could be significantly higher. Under this reading, a project with 100 MW of aggregate nameplate capacity could therefore qualify for the interconnection ITC if each inverter served 5 MW or less of capacity.

The final regulations generally adopt the approach from the proposed regulations, and clarify that the nameplate-generating capacity of each energy property is measured independently from any other energy properties that share the same integral property (e.g., a step-up transformer). The final regulations also add new examples and clarify existing examples to illustrate the application of the rules. In one example, a taxpayer with an interconnection agreement for a maximum output of 10 MW is allowed to claim an interconnection ITC for two solar properties because they each have a net output of 4 MW (as measured in alternating current by using the nameplate capacity of an inverter). Another example illustrates the rule in a case in which multiple energy properties with a net output of 4 MW are treated as a single energy project, and concludes that the owner can calculate the interconnection ITC based on each solar property individually. These clarifications should give the market greater comfort in financing the ITC for interconnection costs.

Apart from the application of the 5 MW limitation, the final regulations provide rules for measuring nameplate capacity for energy properties that generate direct current, and clarify that taxpayers may be required to reduce their ITC-eligible interconnection costs following the receipt of a reimbursement or other payment for the use of the property.

Clarifications Related to the "80/20" Rule

The preamble to the final regulations confirms that, with the exception of the rule for modifications of energy storage, modifications to energy property that has already been placed in service generally do not qualify for an ITC unless they are so extensive as to meet the "80/20" rule, which treats retrofitted property as newly placed in service if the fair market value of new components is at least 80% of the property's total value.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Scott W. Cockerham
scott.cockerham@lw.com
+1.202.637.1003
Washington, D.C.

Jim Cole
james.cole@lw.com
+1.713.546.7435
Houston

Eli M. Katz
eli.katz@lw.com
+1.212.906.1620
New York

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