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Inflation Reduction Act expands tax credits for energy projects

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On Aug. 16, 2022, President Joe Biden signed the Inflation Reduction Act of 2022 (IRA) into law. The key objectives of the IRA include deficit reduction to fight inflation, carbon emissions reduction, and domestic energy production and manufacturing investment. For many years, renewable energy developers have sought to expand the scope and benefit of the investment tax credit (ITC) incentives, and the IRA is a welcome response to those requests.

Of particular note, the IRA expands eligibility to claim the "full" existing energy ITC described in Section 48 of the Internal Revenue Code of 1986, as amended (Code), to certain projects that previously only qualified for a reduced ITC or did not qualify at all, including:

- combined heat and power system property;
- equipment that uses the ground or groundwater as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure (Thermal Energy Property); and
- a newly added category of "energy storage technology."

As amended by the IRA, Section 48 of the Code defines "energy storage technology" as (1) a property that receives, stores, and delivers energy for conversion to electricity or storage and has a minimum nameplate capacity of five kilowatt hours and (2) "thermal energy storage property."

The term "thermal energy storage property" is defined as a property in a system that (1) is directly connected to a heating, ventilation, or air conditioning system, (2) removes heat from or adds heat to a storage medium for subsequent use, and (3) provides energy for the heating or cooling of the interior of a residential or commercial building, provided, however, that this term does not include a swimming pool, combined heat and power system property, a building, or a building's structural components.

In addition to these welcome changes, the IRA also expands the ITC under Section 48 of the Code (Section 48 Credit) to interconnection costs incurred by certain smaller energy projects.

The IRA also expands the Section 48 Credit to qualified biogas property – which involves converting plant-based material to gas -- and microgrid controllers, which monitors energy use in smaller quantities. However, these energy sources are not the focus of this article.

Prior to the IRA, combined heat and power system property and ground and groundwater heating and cooling equipment projects only qualified for a 10% credit on construction that began before Jan. 1, 2024, while energy storage technology was not included in the ITC at all.

For many years, renewable energy developers have sought to expand the scope and benefit of the investment tax credit incentives, and the IRA is a welcome response to those requests.

Under the IRA, the full Section 48 Credit, i.e., the 30% energy ITC, will be available to both combined heat and power system property and energy storage technology projects that begin construction before Jan. 1, 2025. Meanwhile, ground and groundwater heating and cooling equipment projects that begin construction before Jan. 1, 2035, will also be eligible for the full Section 48 Credit, subject to a phase-out for such projects where construction does not begin until after Dec. 31, 2032.

Furthermore, combined heat and power system property and energy storage technology projects that begin construction after Jan. 1, 2025 (and thus not eligible for the Section 48 Credit), can nonetheless qualify for renewable energy tax credits under the new technology-neutral clean electricity ITC (described in the newly added Section 48E of the Code), if the project generates electricity and yields zero greenhouse emissions.

New investment tax credit rate structure

In addition to expanding the Section 48 Credit to additional types of projects, the IRA modifies the Section 48 Credit rate structure, which now includes compliance with new wage and apprenticeship requirements to obtain the full Section 48 Credit.

Following the IRA amendments, the Section 48 Credit is calculated using a set base rate, and the base rate can be increased by a five times multiplier for projects that meet prevailing wage and apprenticeship requirements determined by the U.S. Department of

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Labor. The Section 48 Credit base rate is 6% (as a percentage of the tax basis of eligible energy property) and the multiplier increases it to 30%.

Therefore, renewable energy projects that qualify for the 6% base rate and meet the prevailing wage and apprenticeship requirements will be eligible to receive the "full" 30% Section 48 Credit, which includes combined heat and power system property, Thermal Energy Property, and energy storage technology.

Wage requirements

The IRA requires project owners, contractors, or subcontractors to pay laborers "prevailing wages" during construction and for repairs or alterations performed during the tax credit period. For this purpose, "prevailing wages" refers to wages paid for similar work in the locality of the project site, as determined by the U.S. Secretary of Labor.

If a project owner, contractor, or subcontractor does not pay its laborers "prevailing wages" as required, it can remedy this failure by paying each worker the difference between the prevailing wage and wage actually paid, plus $5,000 per worker and interest. If the project owner intentionally fails to satisfy the wage requirement, additional costs will be imposed.

Apprenticeship requirements

Additionally, the IRA requires a percentage of labor hours based on the minimum number of hours for construction, alteration, or repair work to be performed by qualified apprentices. The labor hours percentage requirement varies depending on the year in which construction begins, as illustrated in the table below.

Transition period relief from wage and apprenticeship requirements

Under relevant transition rules, the IRA provides exemptions from the wage and apprenticeship requirements and automatic qualification for the ITC multiplier for the following projects:

- projects that start construction before the date that is 60 days after the U.S. Treasury Department issues guidance regarding the wage and apprenticeship requirements; and
- projects with a maximum net output of less than one megawatt of electrical or thermal energy.

Small energy project interconnection costs

Moreover, the IRA now permits certain smaller energy projects—projects under five megawatts— to claim the Section 48 Credit with respect to interconnection costs. Previously, interconnection costs were ineligible for the Section 48 Credit. Under the IRA, energy projects under five megawatts can include the cost of qualified interconnection property in the project's basis eligible for the ITC.

The IRA requires project owners, contractors, or subcontractors to pay laborers "prevailing wages" during construction and for repairs or alterations performed during the tax credit period.

For this purpose, "qualified interconnection property" is defined as tangible property, excluding microgrid controllers, that is part of an addition, modification, or upgrade to a transmission or distribution system to facilitate interconnection, which is constructed, reconstructed, erected, or financed by a taxpayer and originally used by a utility under an interconnection agreement.

The new rule applies to various types of energy projects listed in Section 48 and the IRA amendments to Section 48, e.g., wind, solar, qualified fuel cell, qualified biogas property, combined heat and power system, energy storage technology, etc. The application of the Section 48 Credit to interconnection costs may help smaller energy projects manage one of the more daunting energy project expenses.

Conclusion

The IRA significantly reshapes and expands the Section 48 Credit for a broad range of renewable energy resources, including extending eligibility for the full ITC to combined heat and power system property, Thermal Energy Property, and energy storage technology projects, and permitting small energy projects to claim the Section 48 Credit on interconnection costs.

Developers, investors, and other taxpayers with existing qualifying renewable energy projects or who are considering utilizing ITC

Project Construction Period	Percentage of Apprentice Labor Hours
Construction beginning before Jan. 1, 2023	10%
Construction beginning on or after Jan. 1, 2023, and before Jan. 1, 2024	12.5%
Construction beginning on or after Jan. 1, 2024	15%

Source: compiled by the authors

credits and/or participating in the tax equity market for renewable energy should carefully consider the application of the new ITC rules and consult with counsel on the potential benefits and impact of the IRA.

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