

## Congress Revamps Rules for Investment Tax Credit and Production Tax Credit

November 21, 2022

The Inflation Reduction Act (the “IRA”), which became law on August 16, 2022, includes only a handful of tax provisions. Though few in number, the new provisions are expected to have a major impact on taxpayers. The corporate minimum income tax and excise tax on stock buybacks are both entirely new tax regimes implemented under the IRA. In addition, the IRA has introduced major changes to the investment tax credit (the “ITC”) and the production tax credit (“PTC”), which are intended to encourage investment in renewable energy projects, such as solar and wind projects.

Generally, the IRA extends the availability of these tax credits, which were set to expire under prior law, and expands the types of taxpayer who can benefit from them, by implementing a direct pay regime that makes the tax credits available to tax exempt organizations. In addition, the IRA provides new ways for taxpayers to increase the amount of the credits by investing in certain low-income and otherwise disadvantaged communities, and imposes new wage and apprenticeship requirements that should encourage taxpayers to create jobs in connection with constructing and maintaining the facilities that benefit from the ITC and PTC.

The IRA’s modifications to the ITC and PTC provisions are in many ways unprecedented, and the statutory provisions are written with a relatively high degree of generality. The IRS is currently developing guidance on the details of how the new provisions will work, although the exact date that the guidance will appear is unknown. Chapman is monitoring the situation closely and will provide additional updates when the new regulations or other guidance is available.

The remainder of this article provides a general overview of the ITC and PTC rules as modified by the IRA.

### Production Tax Credit Requirements

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#### General Requirements

The amount of the PTC is 2.6 cents (for 2022)<sup>1</sup> per kWh of electricity produced by the taxpayer from “qualified energy resources” at a “qualified facility” and sold to an unrelated person during the 10-year period beginning on the date that the qualified facility is placed in service. Under the IRA, to be eligible for the PTC a facility must begin construction before January 1, 2025.

Qualified energy resources are resources listed in Section 45(c) of the Internal Revenue Code of 1986, as amended (the “Code”), and include energy resources such as wind and solar energy. The definition of a qualified facility generally depends on the type of energy resource, and includes certain solar energy facilities, wind facilities and other types of facility.

#### Prevailing Wage and Apprenticeship Requirements

The IRA imposes new prevailing wage and apprenticeship requirements (the “PWA Requirements”) for a facility larger than 1 MW to access the full PTC amount of 2.6 cents per kWh. The PWA Requirements will be effective on the date that is 60 days after the IRS issues guidance on the PWA Requirements (such date, the “PWA Effective Date”). In the meantime, a facility larger than 1 MW does not have to comply with the PWA Requirements in order to qualify for the 2.6 cent PTC, as long as the facility begins construction before the PWA Effective Date.

With respect to a facility larger than 1 MW that begins construction after the PWA Effective Date, if the facility fails to meet the PWA Requirements its PTC will be limited to 0.3 cents per kWh (instead of 2.6 cents per kWh). A facility with net output of less than 1 MW will not have to comply with the PWA Requirements.

The PWA Requirements consist of a prevailing wage requirement and an apprenticeship requirement. Under the prevailing wage requirement, the wages of any laborers and mechanics employed by the taxpayer or any contractor or subcontractor must be at least equal to the prevailing wages for the relevant professions as determined by the Department of Labor.

Under the PTC rules, a facility must satisfy the prevailing wage requirement throughout the construction of the facility and for the ten-year period beginning on the date that the facility is placed into service.<sup>2</sup> If a facility fails to satisfy the prevailing wage requirement, it can correct the failure by paying (i) additional wages (with interest) to the affected workers to catch them up to what they should have been paid under the prevailing wage requirement, and (ii) a penalty to the IRS of \$5,000 per affected worker. If the IRS determines that the failure to satisfy the prevailing wage requirement is due to intentional disregard, then the facility will be required to pay the affected workers three times the amount described in clause (i), above, and the penalty will be increased to \$10,000 per affected worker.

The apprenticeship requirement consists of the following three requirements:

- 1 A specified percentage of the total labor hours spent on a facility's construction must be performed by "qualified apprentices."<sup>3</sup> The specified percentages are 10% for 2022, 12.5% for 2023, and 15% for 2024 and afterwards.
- 2 The facility must satisfy the apprentice-to-journeyworker ratios established by the Department of Labor or the relevant state apprenticeship agency.
- 3 Each taxpayer, contractor or subcontractor that employs more than four individuals must also employ at least one qualified apprentice.

If a facility fails the apprenticeship requirement, the failure is excused if the facility made a good faith effort to request qualified apprentices from a registered apprenticeship program. Alternatively, with respect to requirements #1 and #3, above, the failure is excused if the facility pays a penalty to the IRS equal to \$50 (increased to \$500 for a failure due to intentional disregard) times the total number of labor hours during which the requirement was not met.

### **Bonus PTCs**

The IRA provides for bonus PTCs if a particular facility meets special requirements. Under the "domestic content" provision, the PTC is increased by 10% (e.g., from 2.6 cents per kWh to 2.86 cents per kWh) if (i) any steel and iron used in the facility is produced in the United States, and (ii) at least 40% (reduced to 20% for an offshore wind facility) of the manufactured products that are used in the facility are produced in the United States. The new provisions specify that eligibility for the domestic content bonus is based on a certification from the taxpayer.

An additional 10% increase is available for a facility located in an "energy community," which generally includes (i) brownfield sites, (ii) certain statistical areas with high unemployment and a history of involvement in the coal, oil or natural gas industries, and (iii) census tracts containing or adjacent to defunct coal mines and coal-fired electricity generation plants.

If a facility qualifies for both bonuses, the bonuses "stack" for a total increase of 20% (e.g., from 2.6 cents per kWh to 3.12 cents per kWh).

## **Investment Tax Credit Requirements**

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### **General Requirements**

The amount of the ITC is the product of (i) the "energy percentage" and (ii) the basis of an "energy property" placed in service during a taxable year. Under the IRA, to be eligible for the ITC a facility must begin construction before January 1, 2025.

The energy percentage for the ITC under the IRA is generally 30%. Energy property consists of certain types of property enumerated in Section 48 of the Code, and includes certain solar, wind and geothermal facilities as well as other types of energy facility.

### Prevailing Wage and Apprenticeship Requirements

Under the IRA, the ITC is subject to PWA Requirements that are similar to the PWA Requirements for the PTC. Like the PTC, the PWA Requirements for the ITC do not apply to a facility that begins construction before the PWA Effective Date.

If a facility larger than 1 MW begins construction after the PWA Effective Date and fails to meet the PWA Requirements, the facility's energy percentage will be reduced from 30% to 6%. In addition, if the facility is eligible for any bonus ITCs for domestic content and energy communities (described below), those bonuses will be reduced from 10% to 2%.<sup>4</sup> Like the PTC, a facility with net output of less than 1 MW will not have to comply with the PWA Requirements in order to access the higher energy percentage for the ITC and the full bonus ITCs.

The most significant difference between the PWA Requirements for the PTC and the ITC is that, in order to be eligible for the full ITC, a facility only has to meet the prevailing wage requirement during the five-year period beginning on the date that the facility is placed in service. (As noted above, to be eligible for the full PTC, a facility has to meet the prevailing wage requirement throughout its construction and for the ten-year period beginning on the date that the facility is placed in service.) In addition, the ITC (unlike the PTC) is subject to recapture if the prevailing wage requirement is not satisfied.

The IRA provides that the ITC is subject to a similar apprenticeship requirement as the PTC, although regulations, when issued, may introduce differences.

The IRA also provides that the ITC is subject to similar correction and penalty provisions for PWA Requirement failures as the PTC.

### Bonus ITCs

The ITC is increased by 10% for a facility that satisfies the domestic content requirement and is also increased by 10% for a facility located in an energy community, both as described in the PTC rules.

The IRA provides an additional bonus ITC for a wind or solar facility with a maximum output of less than 5 MW that is associated with certain low-income groups. The bonus is an additional 10% for a facility located in a "low-income community,"<sup>5</sup> or on "Indian land,"<sup>6</sup> and the bonus is an additional 20% for a facility that is part of a "qualified low-income residential building project"<sup>7</sup> or a "qualified low-income economic benefit project."<sup>8</sup> To qualify for the bonuses described in this paragraph, a taxpayer must be allocated a certain amount of solar and wind generation capacity by the IRS.<sup>9</sup>

The bonus ITCs "stack" much like the bonus PTCs. So, for example, a facility that qualifies for both the 10% bonus ITC for an energy community and the 10% bonus ITC for a low-income community will have its energy percentage increased to 50% (*i.e.*, 30% + 10% + 10%).

## Direct Pay Provisions

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Historically, tax exempt entities have not been able to benefit from tax credits such as the PTC and the ITC, because an entity that does not pay taxes does not have a use for a tax credit. The IRA seeks to change this situation by making certain tax credits refundable. This has the potential not only to encourage tax exempt organizations to invest in renewable energy for their own use, but to allow tax exempt organizations to become investors in tax equity deals and other kinds of financial products tied to tax credits.

Generally, the availability of the direct pay election depends on the status of the borrower and the nature of the underlying investment. The IRA provides that the following types of taxpayers are eligible for the direct pay election:

- Any organization that is exempt from income tax under the Code
- The Tennessee Valley Authority
- An Indian tribal government
- Any Alaska Native Corporation
- Any cooperative corporation engaged in furnishing electric energy in rural areas

The following types of tax credit generally qualify for the direct pay election:

- The credit for alternative fuel vehicle refueling property
- The renewable electricity production credit (for projects placed in service after December 31, 2022)
- The credit for carbon oxide sequestration determined (for projects placed in service after December 31, 2022)
- The zero-emission nuclear power production credit
- The credit for production of clean hydrogen (for projects placed in service after December 31, 2012)
- The credit for qualified commercial vehicles<sup>10</sup>
- The credit for advanced manufacturing production
- The clean electricity production credit
- The clean fuel production credit
- The energy credit
- The qualifying advanced energy project credit
- The clean electricity investment credit

The IRA authorizes the IRS to create a reporting or registration procedure in order to implement direct pay tax credits. We understand that the IRS is currently designing a new tax return to carry out the purposes of this provision.

## Conclusion

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The changes to the ITC and PTC enacted by the IRA are certain to have a significant effect on taxpayers who invest in renewable energy. The statutory language, however, raises many questions, especially with regard to the procedural requirements to claim tax credits under the new provisions.

In particular, aspects of the new rules that rely on statistical information or determinations by non-tax agencies will require guidance. For example, the PWA Requirements incorporate prevailing wage determinations and apprenticeship qualification requirements that are the province of the Department of Labor and related state agencies. Also, qualification for certain of the bonus ITCs and PTCs depends on localized facts, such as the poverty level or unemployment rate in a particular census tract. The IRA does not provide much detail on how taxpayers will determine whether they have met statistical thresholds and substantiate their compliance with the IRS.

Taxpayers and their advisors are eager for the IRS to issue regulations under these provisions, since it will be difficult to determine whether a particular taxpayer qualifies for the PTC or the ITC without further guidance. The IRS has indicated that providing guidance on the IRA's changes to tax credit provisions is a high priority, so hopefully the IRS will issue that guidance soon.

## For More Information

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If you would like further information concerning the matters discussed in this article, please contact Heath Martin or the Chapman attorney with whom you regularly work:

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- 1 This amount is adjusted for inflation.
  - 2 As discussed below, the prevailing wage requirement for the ITC only applies during the five-year period beginning on the date that the facility is placed into service.
  - 3 A qualified apprentice is an apprentice that participates in an apprenticeship program that is registered with the Department of Labor or a state apprenticeship agency under the National Apprenticeship Act of 1937.
  - 4 A failure to meet the PWA Requirements does not affect the bonus ITC for a facility that is located in a low-income community or on Indian land, or that is part of a qualified low-income residential building project or qualified low-income economic benefit project, described below.
  - 5 A low-income community is generally defined as any population census tract if (A) the poverty rate for such tract is at least 20%, or (B) in the case of a tract located outside a metropolitan area, the median family income for such tract does not exceed 80% of statewide median family income, or in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.
  - 6 The IRA defines Indian Land by cross-referencing the Energy Policy Act of 1992. The relevant provisions of that Act define Indian land as (A) any land located within the boundaries of an Indian reservation, pueblo, or rancharia; (B) any land not located within the boundaries of an Indian reservation, pueblo, or rancharia, the title to which is held in trust by the United States for the benefit of an Indian tribe or an individual Indian, by an Indian tribe or an individual Indian, subject to restriction against alienation under laws of the United States, or by a dependent Indian community; (C) land that is owned by an Indian tribe and was conveyed by the United States to a Native Corporation pursuant to the Alaska Native Claims Settlement Act (the "ANCSA"), or that was conveyed by the United States to a Native Corporation in exchange for such land; (D) any land located in a census tract in which the majority of residents are Natives (as defined in the ANCSA); and (E) any land located in a census tract in which the majority of residents are persons who are enrolled members of a federally recognized Tribe or village.
  - 7 A qualified low-income residential building project is defined as a residential rental building which participates in certain housing programs administered under government agencies under laws such as the Violence Against Women Act of 1994, the Housing Act of 1949, and the Native American Housing Assistance and Self-Determination Act of 1996, or such other affordable housing programs as the Secretary may provide. In order to qualify as a qualified low-income residential building project for the purposes of the ITC, the financial benefits of the electricity produced by the facility must be allocated equitably among the occupants of the dwelling units of the building project.
  - 8 A facility is a qualified low-income economic benefit project if at least 50% of the financial benefits of the electricity produced by such facility are provided to households with income of (i) less than 200% of the poverty line applicable to a family of the size involved, or (ii) less than 80% of area median gross income.
  - 9 The IRA directs the IRS to establish this new allocation program within 180 days of the date of the IRA's enactment, which was August 16, 2022.
  - 10 The direct pay option for this credit is only available for (i) federal, state and local governments, (ii) an organization that is exempt from income tax under the Code (other than certain farmers' cooperatives), and (iii) an Indian tribal government.

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