KPMG

KPMG report: Domestic content bonus credit guidance under Notice 2023-38

The IRS on May 12, 2023, released **Notice 2023-38** [PDF 180 KB], providing much awaited guidance on how taxpayers can meet the Domestic Content Requirement[1] and increase their investment or production tax credit amount (ITC or PTC) under sections 45, 45Y, 48, and 48E. To this end, the notice also provides a safe harbor regarding the classification of certain components in representative types of qualified facilities, energy projects, or energy storage technologies. The notice provides favorable treatment for projects containing used property. And finally, the notice provides guidance relating to certification and recordkeeping requirements.

The IRS intends to issue proposed regulations consistent with the guidance in the notice. According to the notice, such proposed regulations will apply for tax years ending after May 12, 2023. Taxpayers may rely on the guidance in the notice for any qualified facility, energy project, or energy storage technology that begins construction before the date that is 90 days after the date of publication of the forthcoming proposed regulations in the federal register.

> **KPMG observation**
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> The Buy America Requirements referenced in H.R. 5376 (commonly called the "Inflation Reduction Act of 2022" (IRA)) are administered by the Federal Transit Administration (FTA). In practice, applying the FTA Buy America Requirements had been difficult for taxpayers, absent guidance more tailored to energy projects.

Background

A main component of the IRA is a refresh and expansion of tax credits for "clean" energy projects. In addition to a base/bonus regime that depends on a taxpayer satisfying certain prevailing wage and apprenticeship requirements, the IRA offers a further credit "adder" (the "Domestic Content Adder") for certain qualified facilities or energy projects placed in service after December 31, 2022.[2] Specifically, the Domestic Content Adder is available to projects under sections 45, 45Y, 48, and 48E. For the PTC under sections 45 or 45Y, the Domestic Content Adder increases the applicable PTC rate per KW/h by 10% (e.g., from 1.5 cents to 1.65 per KW/h prior to the adjustment for inflation). For ITC projects under sections 48 or 48E, the Domestic Content Adder is an increase of 10 percentage points to the applicable ITC rate (e.g., from 30% to 40% of

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[1] Capitalized terms not otherwise defined herein carry the definition provided in the notice, including the list of definitions in Section 3.01(2)(a)-(h).

[2] For purposes of this discussion, we are assuming that any relevant taxpayer has met/will meet the prevailing wage and apprenticeship requirements and is under the "bonus" regime.

qualifying costs). While satisfying the Domestic Content Requirements results in a greater tax credit opportunity, not satisfying domestic content may also result in a haircut to the amount of a credit claimant's "direct pay" tax credit under section 6417, which is applicable for certain tax-exempt entities on the credits discussed herein.[3]

Per the IRA and the notice, the Domestic Content Requirement is satisfied with respect to a project if it meets the:

- Steel or iron requirement; and
- Manufactured product requirement.

Steel or iron requirement

The notice provides that, consistent with Buy America Requirements, any steel or iron which is a component of an applicable project will be considered produced in the United States if all manufacturing processes with respect to the steel or iron take place in the United States, except metallurgical processes involving refinement of steel additives.

This steel or iron requirement applies to project components that are construction materials made primarily of steel or iron and are structural in function. The requirement does not apply to steel or iron used in manufactured project components or subcomponents.

KPMG observation

A helpful clarification is provided that the steel or iron requirement applies only to steel or iron that is structural in function. For example, although bolts, screws, shelves, hinges, and comparable items can be made primarily of steel or iron, these are not treated as structural in function and are not subject to the strict steel or iron requirement.

Manufactured products requirement

Under the IRA, manufactured products are deemed domestically produced if not less than an adjusted percentage of the total costs of such manufactured product are mined, produced, or manufactured in the United States. The adjusted percentage is 40% (20% in the case of an offshore wind facility) for: (1) ITC eligible projects regardless of the begin construction date and PTC projects that begin construction prior to 2025, and (2) increasing to 55% for PTC projects that begin construction in 2027 and thereafter (2028 for an offshore wind facility).

A Manufactured Product is considered to be produced in the United States (a U.S. Manufactured Product) if:

- All of the manufacturing processes for the Manufactured Product take place in the United States, and
- All of the Manufactured Product Components of the Manufactured Product are of U.S. origin.

Importantly, a Manufactured Product Component is considered to be of U.S. origin if it is manufactured in the United States regardless of the origin of its subcomponents.

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[3] This haircut may not apply if a tax-exempt entity eligible for direct pay is unable to source the necessary domestic content.

For ease of reading, the subsequent discussion is limited to the credit increase potential of the Domestic Content Adder.

The notice provides the Adjusted Percentage Rule for purposes of applying the applicable percentage to manufactured products, using the Domestic Cost Percentage.

The Domestic Cost Percentage is determined as follows:

$$\frac{\text{Domestic Manufactured Products and Components Cost (DCP Numerator)}}{\text{Total Manufactured Products Cost (DCP Denominator)}}$$

As stated in the notice, “if the Domestic Cost Percentage for an Applicable Project equals or exceeds the adjusted percentage that applies to the Applicable Project, then the Applicable Project satisfies the Adjusted Percentage Rule.” Meaning if the fraction above is greater or equal to the applicable adjusted percentage, the project satisfies the Adjusted Percentage Rule and **all** Applicable Project Components are deemed to be produced in the United States.

The DCP Numerator includes only direct costs as defined in Treas. Reg. § 1.263A-1(e)(2)(i). The DCP Numerator does **not** include direct materials or labor costs paid or incurred by the Non-U.S. Manufactured Product’s manufacturer to produce the Non-U.S. Manufactured Product.

The DCP Denominator is the sum of the costs of each Applicable Project Component that is a Manufactured Product. As with the DCP Numerator, the DCP Denominator includes only direct costs as defined in Treas. Reg. § 1.263A-1(e)(2)(i).

There is a very helpful example in the section 3.03(2)(d) of the notice that helps explain the application of the Adjusted Percentage Rule. Among many, one helpful takeaway from the example is that for Manufactured Products where 100% of the Manufactured Product Components are produced in the U.S., the indirect costs (i.e., the “missing” $25 for Manufactured Product 1 in the example) all are included in the DCP Numerator. This appears to create a cliff effect where if any of the Manufactured Product Components are non-U.S. **none** of the indirect costs can qualify for inclusion in the DCP Numerator.

KPMG observation

There appears to be a favorable adjustment from the FTA Buy America regulations in the notice with respect to defining what “costs” count toward the DCP Numerator.

The FTA regulations provided that 100% of the components of a manufactured product have to be manufactured in the United States for the manufactured product to “count” as sourced from the United States.

By contrast, the notice appears to provide that even if the manufactured product itself does not count as U.S. sourced—because there is a component that is not US sourced—the cost of the components that **are** U.S. sourced count toward the 40%.

This will make it important for equipment manufacturers to perform their own evaluation of their components and track sourcing and cost information.

Safe harbor

The notice provides a safe harbor classification of common project components in Table 2 on which taxpayers may rely.

An example of the application of Table 2 is that for solar projects, steel photovoltaic module racking is categorized as steel/iron in whole, even if portions of such racking, analyzed separately, would be classified as Manufactured Products.

KPMG observation

The safe harbor is helpful and will not require to taxpayers to make sometimes difficult determinations between steel/iron versus manufactured products. The listed components are not exhaustive though and developers of project types which are not listed (e.g., biogas and combined heat and power) will have to make their own determinations.

Used property

The notice provides that the inclusion of used property does not disqualify a project from the Domestic Content Adder, so long as the fair market value of the used property is not more than 20% of the project's total value calculated by adding the cost of the new property to the value of the used property, often referred to as the "80/20 Rule." The notice references Rev. Rul. 94-31[4] for this purpose, which is commonly used as a guide for renewable energy project repowerings.[5] A project meets the 80/20 Rule for purposes of the Domestic Content Requirement if the new property (the 80%) standing alone meets the Domestic Content Requirement.

Certification requirement, used property, and substantiation

Section 5 of the notice provides guidance on how a taxpayer is to certify to the IRS that its project(s) meet the Domestic Content Requirement. A taxpayer must attach a "Domestic Content Certification Statement" to Form 8835 (for PTCs), Form 3468 (for ITCs), or any other applicable form. This statement must be filed with the taxpayer's annual return for the tax year in which a project claiming the Domestic Content Adder is placed-in-service. For ITC projects, this is the end of the reporting requirements. For PTC projects, the statement must be filed for each year of the entire PTC generation period (10 years, likely 11 years of including the statement[6]).

Finally, the notice provides guidance relating to when and how to certify that Domestic Content Requirements are satisfied and references general recordkeeping requirements under section 6001 for substantiation.

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[4] 1994-1 C.B. 16.

[5] For example, a repowering for a wind project is where a wind turbine is reaching or has reached the end of its 10-year PTC period, but the developer/owner wants to continue to use the location of the turbine to generate wind power (and PTCs). If the developer/owner spends enough money refurbishing the turbine, the wind turbine can be eligible for a new 10-year PTC period post-refurbishment.

[6] As few projects are placed-in-service on January 1.

Conclusion

The notice provides long-awaited guidance implementing the Domestic Content Adder and is helpful to many taxpayers who had been struggling to apply the FTA Buy America regulations to their projects in the meantime. The notice provides clarity around important aspects of these rules, but determinations around Domestic Content, in particular the Manufactured Products Requirement may be challenging in some fact patterns, especially in the case of Manufactured Products with non-US components. Certification and substantiation requirements will also be key considerations, especially when taxpayers are pursuing monetization options for their tax credits. Finally, as issues arise when taxpayers begin to apply this guidance to their fact patterns, feedback and suggestions provided to Treasury and IRS may help inform the future proposed regulations and final regulations.

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