

Unpacking The Proposed Production Tax Credit Regulations

By **Casey August and Jared Sanders** (January 3, 2024, 5:26 PM EST)

The Internal Revenue Service and the U.S. Department of the Treasury published proposed regulations on Dec. 15, 2023, that apply to the advanced manufacturing production credit under Section 45X of the Internal Revenue Code, enacted in 2022 as part of the Inflation Reduction Act.[1]

The proposed regulations are less stringent than many feared and provide helpful rules to assist U.S.-based manufacturers of clean tech energy industry equipment and critical minerals to navigate a credit that became available at the beginning of 2023.

While the guidance is generally straightforward, a fundamental definition remains elusive.

Section 45X Advanced Manufacturing Production Credit

As part of the Inflation Reduction Act's intent to give the clean tech energy industry with incentives to onshore its entire chain of production, Section 45X provides a production tax credit for specified eligible components — either individually or integrated into other eligible components — produced within the U.S. and sold to unrelated persons or, upon election, to related persons.[2]

Eligible components, which must be produced and sold in a taxpayer's trade or business, include finished equipment and component parts of both onshore and offshore wind power generation facilities, solar power generation facilities, electricity inverter equipment, energy storage equipment and critical minerals.

Under the code, the applicable Section 45X credit rate is based on the specific type of component produced and sold. The Section 45X production tax credits remain at their maximum rate until 2030, at which time they will step down by 25% per year until they expire in 2033.

However, the Section 45X production tax credit for critical materials continues in perpetuity without reduction.

Credits claimed under Section 45X are eligible for the Inflation Reduction Act's new monetization methods as follows:



Casey August



Jared Sanders

- Through direct payment under Section 6417 of the code for those types of entities generally eligible for this method of monetization — e.g., tax-exempt and governmental entities;
- Through direct payment under Section 6417 of the code for five years for those types of entities not generally eligible for such a monetization approach — e.g., taxable entities;^[3] and
- Through a credit transfer under Section 6418 of the code.^[4]

The Proposed Regulations

Most notably, Section 1.45X-1 of the proposed regulations provides that the term "produced by the taxpayer" for purposes of Section 45X means:

[A] process conducted by the taxpayer that substantially transforms constituent elements, materials, or subcomponents into a complete and distinct eligible component that is functionally different from that which would result from mere assembly or superficial modification of the elements, materials, or subcomponents.^[5]

While production activities — i.e., substantial transformation — must occur within the U.S., the constituent elements, materials and subcomponents used in the production of an eligible component need not be domestically produced.

Generally, only the taxpayer that directly performs the production activities that bring about the substantial transformation is eligible to claim the Section 45X credit. However, parties entering into a manufacturing arrangement for the production of custom materials or equipment, including a multilateral arrangement, may contractually agree on which party will claim the Section 45X credit.^[6]

The IRS will not challenge such an agreement, provided it contains certain requisite information.

Production of eligible components must have been completed and sales of such eligible components must occur after Dec. 31, 2022, though production may have begun prior to that date.

For a taxpayer to claim a Section 45X credit for an eligible component that has been integrated, incorporated or assembled into another eligible component produced and sold by the taxpayer, the initial eligible component must generally undergo a second production process — i.e., a substantial transformation into "another complete and distinct eligible component" or into a distinct product that is not itself an eligible component.^[7]

For Section 45X-credit amounts that are measured by 10% of the cost of producing the respective eligible component, such as electrode active materials and critical minerals, only production costs are taken into account — not any material procurement or extraction costs.

The preamble to the proposed regulations solicits taxpayer comments as to how extraction costs should be included for determining the credit amount in a manner that protects against duplication of credit amounts across the production chain and builds in safeguards against the possibility for fraud.

For most — but not all — eligible components, substantiation requirements require taxpayers to document that such eligible components meet prescribed technical engineering or physical requirements.

The proposed regulations provide more detailed descriptions and requirements with respect to eligible

components than are provided in the code. Manufacturers would be advised to review Sections 1.45X-3 and 1.45X-4 of the proposed regulations with care to ensure their products comply with the specifications set forth therein.

Sales to Related Persons

Absent a related-person election, a taxpayer that produces and sells an eligible component to a related person is treated as selling such component to an unrelated person only if and when the related person sells such eligible component — or item into which the eligible component has been integrated, incorporated or assembled — to an unrelated person.

If a related-person election is made, the treatment as a sale to an unrelated person is accelerated; the transaction is treated as a sale to an unrelated person at the time the sale is made to the related person.[8]

The IRS may require the related-person election to include information that it deems necessary for purposes of preventing duplication, fraud, or any improper or excessive credit amount determined under Section 45X.

The proposed regulations do not say what information is required to be in such an election, though they suggest as examples the names and employer identification numbers of all related persons, a listing of the eligible components sold, and the intended purpose of the sale to or from the related persons.

A related-person election is made yearly and applies on a trade-or-business-wide basis for sales during that year to all related persons.

Anti-Abuse Rules

No Section 45X credit is allowed if "the primary purpose of the production and sale of an eligible component is to obtain the benefit of the Section 45X credit in a manner that is wasteful, such as discarding, disposing of, or destroying the eligible component without putting it to a productive use." This is a facts-and-circumstances determination.

A similar anti-abuse rule is provided for the related-person election, though it is supplemented by a special rule that prevents the claiming of a Section 45X credit for defective components — i.e., components that do not meet the requirements of Section 45X or the regulations thereunder.

Observations and Takeaways

The proposed regulations strike a balance between setting forth generally straightforward and taxpayer-favorable guidance while guarding against various potential abuses.

One important ambiguity, however, is that the proposed regulations rely on the term "substantial transformation" to define production but do little to explain what such term means.

The definition of "produced by the taxpayer" — i.e., substantially transforming constituent elements or subcomponents into a functionally different eligible component — is a helpful starting point, particularly given that Section 45X does not provide any definition.

However, instead of providing further color on the meaning of this terminology, the proposed regulations focus on what is not substantial transformation, such as mere assembly, superficial modification, partial transformation or the production of only one part of a completed eligible component.

Little is set forth to help taxpayers determine exactly when activities rise beyond those insufficient processes into "substantial transformation."^[9]

Notwithstanding this absence of detail, it is still likely that taxpayers are relieved that the IRS and the Treasury did not choose to institute a more stringent standard, akin to the requirements to qualify for the "domestic content" adder.^[10]

In particular, the decision not to subject constituent elements, materials and subcomponents to a domestic production requirement will allow manufacturers to avoid the difficult process of downstream substantiation and verification, and focus solely on the location of the substantial transformation.

Additionally, the proposed regulations provide practical rules for approaching the production of eligible components, both through multiparty contracts and among related parties.

The flexibility accorded to contract manufacturing arrangements will allow manufacturers, contractors and subcontractors that together produce an eligible component to effectively share the Section 45X credit — e.g., by using the agreed allocation of Section 45X credits to offset or supplement the contract price.

Similarly, the IRS and the Treasury do not appear to establish complicated roadblocks against claiming the related-person election for related-party sales and manufacturing arrangements.

At the same time, the proposed regulations guard against potential abuses by setting forth various rules to avoid the double-counting of benefits, including that only the taxpayer performing the underlying production may claim a Section 45X credit and that certain cost-based Section 45X credits do not take into account component costs.

Furthermore, broad anti-abuse rules put taxpayers on notice that wasteful production activities, including through the abuse of transactions between related parties, will not be tolerated.

In doing so, the IRS and the Treasury recognize that the Section 45X credit can provide incentives to produce equipment and other materials in a way that has no commercial reality and does not further the policy goals underlying the credit — contribution to the development of secure and resilient supply chains — especially when the benefit of the Section 45X credit exceeds the cost of production.

One final point of interest is that, unlike other recent guidance in the form of IRS notices and other proposed regulations, the proposed regulations do not explicitly state that taxpayers may rely on them pending forthcoming final regulations. Furthermore, it is not entirely clear from the proposed regulations whether, once finalized, the regulations will be retroactive back to 2023. Hopefully, the IRS and the Treasury will make the standard of interim reliance clear.

Jared Sanders is an associate at the firm.

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[1] <https://www.govinfo.gov/content/pkg/FR-2023-12-15/pdf/2023-27498.pdf>.

[2] <https://www.morganlewis.com/pubs/2022/08/inflation-reduction-act-would-significantly-expand-federal-income-tax-benefits-for-green-technology-industry>.

[3] <https://www.morganlewis.com/pubs/2023/06/inflation-reduction-act-guidance-proposed-on-direct-payment-for-energy-credits>.

[4] <https://www.morganlewis.com/pubs/2023/06/irs-and-treasury-release-credit-transfer-guidance-aiming-to-jump-start-market-for-iras-clean-tech-industry-tax-credit-sales>.

[5] A special rule is provided with respect to solar grade polysilicon, electrode active materials, and applicable critical minerals, for which the term "produced by the taxpayer" means "processing, conversion, refinement, or purification of source materials, such as brines, ores, or waste streams, to derive a distinct eligible component." Notably, costs related to the extraction of raw materials are not included as production costs, though the Treasury and the IRS continue to consider whether to include such costs.

[6] A contract manufacturing arrangement is defined for these purposes simply as an agreement providing for the production of an eligible component, provided that the agreement is entered into before production thereof is complete. The proposed regulations include a few specific exceptions to this definition intended to ensure that such components are custom made rather than supplied from inventory.

[7] For solar grade polysilicon, electrode active materials, and applicable critical minerals, the secondary "production" process includes the processing, conversion, refinement, or purification of an eligible component to derive a distinct eligible component, that is solar grade polysilicon, electrode active materials, and applicable critical minerals.

[8] For purposes of Section 45X, two persons are treated as related if they are treated as a single employer under Section 52(b) of the code.

[9] Taxpayers may seek guidance from preexisting Treasury regulations that use the term "substantial transformation." Most notably, the cross-border subpart F rules include "substantial transformation" as a manufacturing activity excluded from foreign-based company sales income. In that context, however, guidance is also limited — the few examples in the regulations for substantial transformation consist of the conversion of wood pulp to paper, steel rods to screws and bolts, and the canning of fish.

[10] <https://www.morganlewis.com/pubs/2023/05/irs-releases-highly-anticipated-guidance-on-domestic-content-ira-tax-credit-adder>.