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Tax update

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Impact of the Inflation Reduction Act on the real estate industry

The Inflation Reduction Act (the "IRA") is a historic piece of legislation that includes approximately $369bn of funding for a number of strategies to reduce carbon emissions and combat climate change. Although it may be tempting to assume that the IRA is only relevant for the energy and manufacturing sectors, there is plenty in the IRA relevant to the commercial real estate industry as well. In fact, there are some key tax incentives that can benefit property owners and developers, all while moving the United States closer to its "net zero" decarbonization goal.

The IRA is jam packed with tax credits and other incentives that will have an impact on many industries, so this note focuses on just a few highlights that are most relevant for the real estate industry. Reach out to a member of the Hogan Lovells Tax or Real Estate teams for a more in-depth discussion on how your property or project may benefit.

Incentivizing new development of clean energy – the ITC, PTC, and other benefits

The backbone of clean energy tax incentives has historically been the investment tax credit (the "ITC") and production tax credit (the "PTC"), and those credits are expected to play a key role going forward as well. The IRA made a number of changes to the ITC and PTC, so let's start with a quick summary of each and how the real estate industry can get into the game.

ITC and PTC – Just the basics

The ITC encourages investment in solar, wind, and certain other kinds of renewable energy through a one-time credit that is available at the time a qualifying project is placed in service. The base credit is equal to 6% of a taxpayer's cost basis in its eligible property, but the credit can be increased to 30% if certain prevailing wage and apprenticeship requirements are satisfied, as described below. Note that the ITC is subject to recapture if the investment credit property is sold or otherwise ceases to qualify within five years from the placed in service date. The ITC vests at a rate of 20% per year so the amount subject to recapture decreases with each year.

The PTC is an ongoing 10-year credit for the production of renewable electricity at a qualified facility sold to an unrelated person. The base credit is equal to the kilowatt hours produced and sold, multiplied by 0.3 cents, adjusted for inflation (currently at 0.52 cents for 2022). However, like the ITC, the PTC can be increased by a multiple of five if certain prevailing wage and apprenticeship requirements are met (i.e. 2.6 cents/KwH for 2022). Owners of certain projects, such as solar and wind, are able to choose between the ITC and the PTC.

Prevailing wage and apprenticeship – Training the next generation

The green energy provisions of the IRA are, in the first instance, aimed at reducing carbon emissions and encouraging a move to clean electricity. However, the IRA also contains a number of economic development and social justice tools. The wage and apprenticeship requirements are part of this second policy prong.

The prevailing wage requirement generally requires that laborers and mechanics that work on the construction, alteration, or repair of a qualifying facility must be paid prevailing wages in the location in which the project is located. The "prevailing wage" is determined by the Davis Bacon Act, which sets prevailing wage rates determined by the Department of Labor that must be observed by federal contractors and subcontractors working on certain construction, alteration, and repair projects.

Under the apprenticeship requirement, a minimum percentage (ranging from 10% to 15% depending on when the project begins construction) of total labor hours spent on construction, alteration, and repair work must be performed by qualified apprentices.

There are some resources currently available on the Department of Labor's website, but there are plenty

of open questions. For example, how will taxpayers prove compliance, and what kind of certifications or filing requirements will there be? Also, will off-site work also need to comply? A project will certainly engage workers on-site, but there will likely be off-site work as well (materials may need to brought to the site by the project's employees, for example), and the current prevailing wage rules that apply to government contractors only apply to on-site work.

Luckily, the Treasury Department is prioritizing guidance on these requirements given how critical they are to being able to claim the maximum credit. As described above, if the prevailing wage and apprenticeship requirements are not satisfied, the taxpayer will only receive the base amount of the ITC or PTC. Moreover, the wage and apprenticeship requirements only go into effect 60 days after the day that the Treasury Department issues clarifying guidance. All projects that are or were "under construction" before this effective date are grandfathered, so they are deemed to satisfy the prevailing wage and apprenticeship requirements, and are therefore eligible for the full PTC and ITC, as long as certain continuous construction requirements are satisfied.

Bonus status – Location, location, location

Here is where real estate starts to matter! The IRA juices the credit amount with "bonus" credit levels for property produced or located in certain geographic areas. If you are otherwise eligible for the ITC or PTC (and even some other clean electricity credits), your credit amount can increase by 10% if the project is located in an "energy community". This means that the ITC would go from 30% to 40%, and the PTC amount would go up 10% (for example, from 2.6 cents/KwH to 2.86 cents/KwH). Note that the ITC may be a better choice if you are bonus eligible, but any project will require modeling to figure out which credit is the most advantageous.

An energy community includes (1) brownfield sites, (2) areas that meet, or met, certain minimum employment levels in, or a specified percentage of local tax revenue from, the coal, oil, or natural gas industries, and (3) areas where coal mines have closed. This is another area needing additional guidance from the Treasury Department, but once we get clarity on what the energy community map looks like, you can expect additional investment in those areas. Even if you are not in the business of developing wind farms, anyone owning land in those areas should understand the increased value of their property as a result. Also, if a new energy production facility is being constructed in one of these areas, that means more employees (being well-trained and well-paid due to the wage and apprenticeship requirements!) needing places to live, eat, shop, etc.

There is also a 10% ITC and PTC bonus for projects that meet a domestic content requirement, which generally requires that a minimum percentage of project components be manufactured in the United States. Lastly, for the ITC only, there is a 10% bonus for wind and solar projects located in low-income communities or on tribal land, and a 20% bonus for projects located in qualified low-income residential building projects. If you have an Opportunity Zone project underway in a low-income community, take note!

The bonus credits are stackable, so if you develop a qualifying energy facility in an energy community that is also a low-income community, you meet the domestic content requirements, and you meet the wage and apprenticeship requirements, your ITC would be 60%. This is an incredibly powerful incentive that can make these projects "pencil out" fairly easily. For example, if your project has a total cost of $10m, you would be eligible for a $6m credit as soon as it is placed in service.

Property owners can (and should) develop clean energy facilities and new tech

Perhaps developing a new nuclear facility is not in your wheelhouse? Fair enough, but you can put solar panels on the roof of your multifamily or industrial property. In addition to lowering the energy costs of the property, the tax credits can be a powerful incentive to decarbonize our energy consumption.

The IRA also revived a credit for "qualified alternative fuel vehicle refueling property" (translation – this means electric vehicle charging stations). You can claim a 30% credit, assuming the wage and apprenticeship requirements are met, for the cost of the EV charging station, up to a maximum of $100,000 per station. The EV charging station credit does have some geographic limits though, so you can only claim the credit if it is placed in service in an eligible census tract, which for this purpose is (i) a low-income community (Opportunity Zone developers, here's another one for you!) or (ii) not an urban area (urban areas meet minimum population density requirements measured by the most recent census data). With California and New York banning new gas powered vehicles beginning in 2035, and others likely to follow, EV charging stations will no longer be amenities but will become necessities.

cleaned up a few existing incentives for reductions in energy usage.

Energy efficient commercial buildings

The IRA made a number of user-friendly changes to an existing deduction under Section 179D (the "179D Deduction") of the Internal Revenue Code of 1986, as amended (the "Code"). The 179D Deduction encourages commercial building owners to install energy-efficient systems by providing an immediate deduction for those costs, as opposed to capitalization.

Very generally, if the building's energy systems result in sufficient energy savings as compared to a reference building, the owner can claim a 179D Deduction for the costs of the energy efficient property. The deduction is based on the building's square footage. Here are the high-level takeaways for new improvements placed into service beginning in 2023:

- The IRA increases the deduction amount to a maximum of $5/square foot, as compared to a maximum of $1.88/square foot under prior law.
  - The total deduction is based on building size, so larger buildings will generate larger deductions.
  - For example, if an energy efficient lighting system is installed at a cost of $1m in a 100,000 square foot building, the maximum deduction at $5/square foot would be $500,000. The remaining $500,000 tax basis in the lighting property would be subject to depreciation in accordance with the appropriate cost recovery period.
- The minimum required reduction in energy and power costs is reduced from 50% down to 25%, although to receive the maximum deduction the energy reduction must still be 50%.
  - This is a sliding scale, so under the lighting system example above, if the lighting system only reduces energy by 25% as compared to the appropriate reference mark, the deduction would be $250,000. The full $500,000 deduction is available if the energy reduction is 50% or more.
- The prevailing wage and apprenticeship requirements discussed above must be met to claim the full deduction, otherwise the per square foot deduction is reduced by 80%.
  - For example, if the property would otherwise qualify for a $5/square foot deduction, but the prevailing wage and apprenticeship requirements are *not* met, the deduction is reduced to $1/square foot.
  - Again, under the example above, if the lighting system results in a 50% energy reduction, but the prevailing wage and apprenticeship requirements are not met, the deduction drops from $500,000 to $100,000.
- Under prior law, the 179D Deduction could only be claimed once, which meant that property owners could not claim the 179D Deduction for subsequent energy efficient improvements. The IRA removed this limit, and taxpayers can now claim the 179D Deduction every three years (or four years, for tax-exempt entities) if additional energy improvements are placed in service.
- All tax-exempt entities, including charities, religious institutions, educational institutions, and even REITs for this purpose, can allocate the 179D Deduction to the building "designers" (architects, engineers, etc.). Previously, only government entities that owned buildings could allocate the deduction to building designers.
  - This is on the (long) list of items that we will be waiting for the Treasury Department to provide guidance on, but tax-exempt entities that are developing or improving their property should keep this new benefit in mind when negotiating with building designers.

The 179D Deduction still requires an independent engineer to certify the energy savings, and there are existing 179D consulting firms that can help to navigate the requirements. However, with the lower energy reduction threshold and increased deduction amount per square foot, it may be worth jumping through all the administrative hoops for the tax savings.

Energy efficient homes

The IRA also resurrected a tax credit under Section 45L of the Code (the "45L Credit") that expired last year. The 45L Credit is a great incentive for developers of energy efficient residences.

Beginning in 2023, and continuing through 2032, a developer can receive a 45L Credit for each "dwelling unit" that is sold or leased. The amount of the credit ranges from $2,500 (for units that meet the EnergyStar benchmark) to $5,000 (for units that meet the Department of Energy's Zero Energy Ready Homes (ZER) requirement). Multifamily units need to meet the prevailing wage requirement, or else the

credit drops to $500 (EnergyStar) and $1,000 (ZER), but single-family and manufactured homes do not.

The 45L Credit will be available for residential projects of any size, unlike pre-IRA where buildings had to be no more than three stories high.

Similar to the179D Deduction, the 45L Credit requires some administrative steps, such as certification that the required energy criteria are met, so developers should make sure to plan ahead and include the required inspections during the construction process.

The 45L Credit can be claimed along with the 179D Deduction, if applicable, making this another place where you can stack your benefits.

The indirect benefits for the real estate industry

It is true that many of the IRA tax incentives will not be claimed directly by those in the real estate industry (i.e. the carbon capture credit, the zero-emission nuclear power PTC, the sustainable aviation fuel credit, etc.). However, there will be a tremendous amount of new energy infrastructure as a result of the IRA, and the real estate industry can be in the right place at the right time to indirectly benefit from the resulting boom in U.S. industry.

For example, there is a new PTC available for the domestic production and sale of solar and wind components under Section 45X of the Code, which is intended to help kickstart U.S. production of supply chain items needed to develop those green energy facilities. This credit has several attractive features for manufacturers, including a direct pay option (meaning that manufacturers can get a cash refund if they do not have sufficient tax liability to absorb the credit) and the absence of wage and apprenticeship requirements. Because the credit requires domestic production, there will be demand for new facilities. (Ahem, developers of industrial properties, this means you!)

As noted above, there is a 10% bonus to the ITC and PTC for energy facilities that meet the domestic content requirement, translating to more U.S. manufacturing for construction components. Similarly, the automotive industry is in the midst of a pivot to establish more U.S. assembly facilities for electric vehicles, since the consumer EV credit is only available for EVs that have their final assembly in North America. The real estate industry can and should position itself to help manufacturers get the properties and improvements they need to get those assembly lines up and running.

Lastly, for anyone with friends who happen to have areas of underutilized land, this may be a good time for them to cash in. There are some staggering estimates for the amount of land that will be required to develop new wind farms and solar arrays to help meet the anticipated uptick in electricity.

What's next for the new IRA provisions?

As everyone absorbs the IRA and what it means for their particular industry, it is clear that there are plenty of unanswered questions. The Treasury Department has already solicited comments on the types of questions that it should answer first. It is notable that Treasury is asking for input at this early stage, as opposed to proposing guidance first and letting stakeholders react second. By asking industry participants what they need to know to successfully structure projects to be in compliance with the new law, hopefully the guidance process can be fairly efficient.

Some of the updated incentives have a fairly well established set of rules, such as the 179D Deduction and the 45L Credit, since those provisions have been around for a while. Of course any new aspects of those incentives, like the wage and apprenticeship requirements, will need clarification, which will hopefully happen sooner rather than later.

In the meantime, we are seeing reactions to the IRA happen in real time as companies plan for new U.S. facilities and consumer demand for EVs spikes. The real estate industry has a role to play in our country's decarbonization efforts, and also stands to benefit from the IRA's many tax incentives.

This Tax update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed in this update.

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