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Business Tax Deductions for Energy-Efficient Construction are Enhanced in 2023

Mitigating the adverse effects of climate change is one of the primary goals of the Inflation Reduction Act (IRA) enacted in 2022. The federal legislation is packed with tax incentives, including the significant expansion and extension of two tax deductions for energy-efficient construction.

Sec. 179D Deduction Changes in the Inflation Reduction Act

The Sec. 179D deduction has been around since 2006, but the Consolidated Appropriations Act only recently made it permanent. The IRA adds changes that substantially boost the size of the potential deduction and expand the pool of eligible taxpayers.

Previous Section 179D Energy Efficiency Deduction Limits

Pre-IRA, the deduction generally was limited to owners of commercial properties or residential properties four stories or higher. The deduction could also be assigned to “designers” (including architects and engineers) of government-owned buildings.

To claim the deduction, a taxpayer was required to show a 50% reduction in energy and power costs. The deduction amount was up to 63 cents per square foot for each of three eligible systems (HVAC and hot water, interior lighting, and building envelope). The maximum deduction was \$1.88 per square foot (adjusted for inflation). Taxpayers could get a partial deduction if they couldn’t show the requisite savings in all three systems, and the deduction could be claimed only once per property.

Section 179D Deduction Changes via the IRA for 2023

The IRA makes some major changes starting on January 1, 2023. For starters, the qualification threshold drops to 25% energy savings, with a base deduction of 50 cents per square foot.

If, however, the project satisfies prevailing wage and apprenticeship requirements for laborers and mechanics, you can qualify for the so-called “bonus” deduction of up to \$2.50 per square foot. This deduction amount increases on a sliding scale:

- If you qualify for the bonus, your deduction increases by 10 cents for each percentage point of energy savings above 25%, up to a 50% reduction, maxing out at \$5 per square foot.

- If you don't qualify for the bonus, your deduction increases by 2 cents for each percentage point of energy savings beyond 25%, again up to 50%, for a maximum deduction of \$1 per square foot.

The IRA brings other changes, too. For example, it eliminates the availability of partial deductions, and it allows all tax-exempt entities — not just government entities — to assign their deductions to designers.

The law also revises the standard for determining the amount of energy savings. Currently, the determination is made using the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) standard in effect two years prior to the start of the construction. Under the IRA, however, energy savings will be evaluated under the ASHRAE standard from four years prior to completion of construction.

In addition, the deduction is no longer “one and done.” You can claim it again every three tax years (four years for buildings that are owned by government or tax-exempt entities) for subsequent energy-efficient improvements.

And the IRA creates a new alternative deduction path for renovation projects. To be eligible, you must have a qualified retrofit plan and reduce the building's energy use “intensity” by at least 25% (as opposed to annual energy and power costs) compared to before the retrofit. Qualifying taxpayers can claim the retrofit credit in the qualifying final certification year. The deduction amount can't exceed the total adjusted basis of the retrofit property placed in service.

In January 2023, the IRS issued an announcement notifying taxpayers of applicable reference standards to be used in determining the amount of energy efficient commercial building property deductions allowed under Sec. 179D. The announcement identifies existing reference standards, affirms new reference standards, and clarifies when each of those standards will apply. (Announcement 2023-1, 2023-01).

Sec. 45L Credit Changes in the Inflation Reduction Act

The Sec. 45L credit also first became available in 2006, but it expired at the end of 2021.

History of the Sec. 45L Credit

The credit applied to “eligible contractors” that built energy-efficient, single-family manufactured and low-rise multifamily residences. To qualify, the residences had to be 50% more energy-efficient than a standard dwelling unit that complies with the 2006 International Energy Conservation Code standards. The maximum credit was \$2,000 per unit, with no partial credit permitted.

Section 45L Changes via the IRA for 2023

The IRA revived the Sec. 45L credit, extending it in its original form for qualifying buildings placed in service in 2022, with the same eligibility requirements and credit amount. Beginning in 2023 and running through 2032, though, the credit will be available for residential properties of any size, including

those that exceed three floors. This means that multifamily properties that are four or more floors will be able to qualify for both 179D deductions and 45L credits.

However, the IRA imposes more stringent standards for determining energy savings. Properties must satisfy the U.S. Department of Energy's Energy Star Manufactured New Homes Program or Energy Star Residential New Construction Program requirements.

The base credit amount changes in 2023, too. It increases to \$2,500 per unit for single-family Energy Star homes and falls to only \$500 per unit for Energy Star multifamily homes. But taxpayers might qualify for much larger credits by fulfilling additional criteria.

If a property meets the requirements for the even stricter Zero Energy Ready Home program, the credit jumps to \$5,000 per single-family unit and \$1,000 per unit for multifamily homes. The credit for an Energy Star multifamily property goes up to \$2,500 per unit if the property satisfies prevailing wage requirements, or \$5,000 per unit if it's also Zero Energy Ready.

Make the Most of the IRA's Energy-Efficient Construction Deductions

The Sec. 179D and 45L incentives are only the tip of the iceberg when it comes to the IRA's energy-related tax provisions affecting both personal and business property. [Reach out to your Seiler tax advisor](#) for help in leveraging all the applicable opportunities to minimize your federal tax liability.

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