Direct Pay Tax Credits and Output Facilities

Chair:

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<u>Session Description</u>: The Inflation Reduction Act (IRA) created direct pay tax credits to tax-exempt entities for qualifying green energy projects (as well as certain other categories of projects). This panel will discuss issues surrounding those credits, including issues for tax-credit eligible projects financed with tax-exempt bonds that are treated as output facilities.

<u>Substantive Outline:</u>

I. The Basics

A. Tax credit vs tax deduction

B. Taxpayer vs tax-exempt entity

1. Need for income tax liability to utilize

a) Historic approach to use of tax credits by tax-exempt entities -

(i) PPA structures (e.g., have credit earned by tax-paying entity)

(ii) Just ignore credit availability altogether (e.g., some CA school districts)

b) Use by taxable entities –

(i) start-ups (no income for some period) vs entities with current tax liability,

(ii) partnership flip structures,

(iii) often a key financial element to an energy project financing

2. Credits are subject to limits and offsets (anti double dipping rules such as reduction in depreciable basis and reduction of credit amount where the facility uses tax-exempt financing).

C. Production tax credit (PTC) vs investment tax credit (ITC)

1. PTC mechanics – the taxpayer receives an annual tax credit for a set period based on the amount of qualified output.

2. ITC mechanics – the taxpayer receives a credit in the year the eligible facility is placed in service in an amount determined on the basis of a specified percentage (historically 30%) of the cost basis of the facility.

a) In the case of energy property the cost basis of the facility for depreciation purposes is reduced by an amount equal to 50% of the amount of credit allowed. Code § 50(c).

b) ITC "vests" over a 5-year period. If the project is sold within that 5-year period any unvested credit is recaptured. See Code § 50(a)(1).

3. For both the PTC and the ITC the credit amount usually, but not always, is subject to reduction where the qualified facility is financed in whole or part with tax-exempt bonds.

D. New tax credit monetization rules

1. Code § 6417 – refundable tax credit for tax-exempt entities.

a) Allows an electing "applicable entity" to be treated as having made a payment of "applicable credits." Code § 6417(a)

b) Under Code §6417(d)(1)(A) "applicable entities" include -

(i) Tax exempt entities (e.g., under Code § 501(c)(3))

(ii) State or political subdivision

(iii) Tennessee Valley Authority

(iv) Indian tribal governments

(v) Alaska Native Corporation

(vi) Electric cooperatives serving persons in rural areas

c) See Part II below for a discussion of "applicable credits" under Code § 6417(b).

2. Code § 6418 – transfer of certain tax credits.

a) Allows an "eligible taxpayer" to elect to transfer all or part of an "eligible credit" to an unrelated third party "transferee taxpayer."

b) Under Code § 6418(f)(2) the term “eligible taxpayer” includes any taxpayer not described in Code § 6417(d)(1)(A), as summarized above in section D.1(b) of this outline.

c) Under rules relating to the tax treatment of payments by the transferee taxpayer, a payment under this provision -

(i) Must be made in cash,

(ii) Will not to be included in the income of the eligible taxpayer that receives the payment, and

(iii) Will not be deductible by the transferee taxpayer making the payment.

d) This provision could prove useful in bond-financed project financings where the developer in the early years of operation may not have the taxable income necessary to take advantage of the credit as soon as it is earned.

e) See Part II below for a discussion of “eligible credits” for purposes of Code § 6418.

II. Tax Credits Eligible for Monetization or Which Have Tax-Exempt Financing Potential.

A. Cautionary note: the various tax credit provisions discussed below are similar in many respects, but they also are quite varied. Even within individual credit provisions there are variations in eligibility for and the amount of credit based in factors such as start of construction, placed-in-service date, facility output, facility location, etc. The details of these variations are beyond the scope of this presentation, but certainly merit attention in practice.

B. For purposes of Code § 6417 the term “applicable credit” as defined in Code § 6417(b), includes the following:

1. PTC under Code § 45(a), the “renewable electricity production credit” for qualified facilities placed in service after 2022.

a) In general, the credit for each year is equal to a stated amount per kilowatt hour (“kWh”) of electricity from a “qualified energy resource” times the number of kWhs sold during the year. Under current law, the credit applies only to electricity sold to an unrelated party, but beginning in 2025 the credit may be claimed as long as there is an independent entity metering the production.

b) The amount of the credit per KWh, and the number of years for which the credit is available, vary depending on the type of facility involved. There is a “base” credit, which can be increased (5x) to the

historic standard credit rate if the project meets certain prevailing wage and apprenticeship requirements, which would bring the credit amount up to the "historic" PTC rate. Additional credit may be available in respect of facilities located on brownfield sites or in certain low income areas, or facilities meeting domestic content requirements.

c) Tax-exempt financing "haircut" – the otherwise allowable PTC under Code § 45(a) is reduced, but not by more than 15%, by a fraction the numerator of which is the portion of the cost of the qualified facility financed with tax-exempt bonds and denominator is the total cost of the qualified facility. Stated differently, if the portion of the cost of the qualified facility financed with tax-exempt bonds is equal to or greater than 15% the allowed credit is reduced by that amount.

d) Qualified facilities are facilities that meet various requirements relating to start of construction, placed in service date, etc.

e) Qualified energy resources include:

(i) wind,

(ii) closed-loop biomass,

(iii) open-loop biomass,

(iv) geothermal energy,

(v) solar energy,

(vi) small irrigation power,

(vii) municipal solid waste,

(viii) qualified hydropower production, and

(ix) marine and hydrokinetic renewable energy.

(x) In the case of facilities that may qualify either for a PTC or an ITC, the taxpayer must make an irrevocable election to claim one or the other, but not both.

2. Energy ITC under Code § 48.

a) The amount of the ITC under section 48 is based on a percentage of the qualifying basis of the "energy property." As amended by the Inflation Reduction Act, there is a base rate of 6%, which can be increased to the historic standard rate of 30% if certain prevailing wage and apprenticeship requirements are met.

b) In addition, there are additional bonuses to the credit amount for meeting certain domestic content requirements, and for projects in defined "energy communities." There also is an annual allocation by Treasury of additional bonuses for wind and solar projects located on tribal lands or low-income housing projects.

c) Tax-exempt financing "haircut" – the otherwise allowable ITC under Code § 48 is reduced, but not by more than 15%, by a fraction the numerator of which is the portion of the cost of the qualified energy property financed with tax-exempt bonds, and the denominator is the total cost of the qualified facility. Stated differently, if the portion of the cost of the qualified energy property financed with tax-exempt bonds is equal to or greater than 15%, the allowed credit is reduced by that amount.

d) For purposes of Code § 48 the following types of property qualify as energy property eligible for ITC:

(i) solar energy equipment (e.g., to produce electricity or to heat or cool,)

(ii) solar energy equipment that illuminates the inside of a structure using fiber-optic distributed sunlight, or electrochromic glass,

(iii) geothermal energy equipment,

(iv) qualified fuel cell property or qualified microturbine property,

(v) combined heat and power system property,

(vi) qualified small wind energy property,

(vii) equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, but only with respect to property the construction of which begins before January 1, 2035,

(viii) waste energy recovery property,

(ix) energy storage technology,

(x) qualified biogas property, or

(xi) microgrid controllers.

(xii) ITC eligible facilities also include certain facilities eligible for production tax credit. This essentially gives the taxpayer an

election to choose whether to take a PTC or ITC (but not both). Facilities for which this election is available include

(a) wind energy facilities,

(b) closed loop biomass facilities,

(c) open loop biomass facilities,

(d) geothermal or solar energy facilities,

(e) landfill gas facilities,

(f) trash facilities,

(g) qualified hydropower facilities, and

(h) marine and hydrokinetic renewable energy facilities.

3. Other eligible credits for purposes of Code §§ 6417 and 6418:

a) Code § 45Q – PTC for carbon oxide sequestration. Eligible facilities can be financed with exempt facility bonds under new Code § 142(o), which was added by the IRA. Code § 6417 also may benefit governmental electric utilities that add carbon abatement facilities to new or existing power plants. Under the changes made to this section by the IRA, the tax-exempt financing haircut is limited to 15%; previously the reduction was up to 50%. For taxpaying entities (those not otherwise eligible for the direct payment under Code § 6417), there is the ability to elect to receive a direct payment of this tax credit.

b) Code § 45U – PTC for zero emission nuclear power from already-in-service nuclear power projects. There is no tax-exempt financing haircut.

c) Code § 45V – PTC for clean hydrogen production. There is no tax-exempt financing haircut. For taxpaying entities (those not otherwise eligible for the direct payment under Code § 6417), there is the ability to elect to receive a direct payment of this tax credit.

d) Code § 45W – Per vehicle credit for qualified commercial clean vehicles. There is no tax-exempt financing haircut. This credit is eligible for a direct payment under Code § 6417, but not eligible for the sale under Code § 6418.

e) Code § 45X – PTC for advanced manufacturing production. There is no tax-exempt financing haircut. For taxpaying entities (those not otherwise eligible for the direct payment under Code § 6417), there is the

ability to elect to receive a direct payment of this tax credit, but only for a 5year period (otherwise qualified for a 10 year period for the PTC).

f) Code § 45Y – PTC for clean electricity generating facilities placed in service after 2024, which is technology neutral (no limited list of qualifying facilities). This will supersede the Code § 45 PTC beginning in 2025, and otherwise includes similar prevailing wage/apprenticeship/domestic content provisions. It is subject to an up to 15% tax-exempt finance haircut.

g) Code § 45Z – Clean fuel PTC. Potentially available for facilities that produce aviation fuel from biomass and therefore potentially eligible for financing with exempt facility solid waste disposal facility bonds. There is no tax-exempt finance haircut.

h) Code § 48B – ITC for qualifying gasification project. Gasification facilities using biomass (which may be solid waste) as a feedstock may be eligible for exempt facility financing. This credit is not eligible for monetization under Code § § 6417 or 6418. Credit amount subject to allocation by Treasury Secretary but there is no tax-exempt financing haircut.

i) Code § 48C – ITC for qualifying advance energy project. Potentially applicable to solid waste recycling facilities financed with exempt facility bonds. Credit amount subject to allocation by Treasury Secretary but there is no tax-exempt financing haircut.

j) Code § 48D – ITC for advance manufacturing facilities, defined as facilities used primarily for the manufacturing of semiconductors or semiconductor manufacturing equipment. Such facilities often contain fairly substantial solid waste processing facilities, and thus may be financeable in part with exempt facility bonds. There is no tax-exempt financing haircut. Also, the credit is not eligible for monetization under Code § § 6417 or 6418.

k) Code § 48E – ITC for clean electricity generation and energy storage facilities placed in service after 2024, which is technology neutral (no limited list of qualifying facilities). This will supersede the Section 48 ITC beginning in 2025, and otherwise includes similar prevailing wage, apprenticeship, and domestic content provisions. This provision was added by the IRA, and may have application to public utilities and other governmental users. This credit is subject to an up to 15% tax-exempt finance haircut.

III. Various Issues for Direct Payments of Tax Credits under Code § 6417.

A. Election to claim Direct Payments of Tax Credits.

1. For entities that file tax returns (i.e., 501(c)(3) organizations), the election is due on the return filed for the tax year in which the project is placed in service.

2. For entities that do not file tax returns, the timing will be provided in guidance by Treasury.

3. Possibility of significant delay? If a qualifying project is placed in service in 2023, the election to claim the tax credit may not happen until the tax return filed in 2024 for the 2023 tax year, with the payment to be received sometime later.

B. Timing Issues with the Tax-Exempt Financing.

1. Allocations of Proceeds/Reimbursements.

a) For tax credits with a haircut for tax-exempt financing, it generally will be necessary to determine the amount of the project financed with tax-exempt bonds at the time the tax credit is claimed. However, the tax-exempt financing rules generally provide flexibility to allocate or reallocate proceeds for some period of time, and in the case of reimbursement expenditures, bonds could potentially be issued up to 18 months after the project is placed in service. Guidance may be forthcoming on these issues.

b) A separate issue may arise in the context of, for example, a campus-wide capital project (e.g., new dormitory or academic buildings, a new parking facility, and an energy system upgrade) which includes as one of its constituent elements a project eligible for Code § 48 ITC. Presumably the portions of the overall project required to meet the domestic content and prevailing wage requirements will be only the portion of the project that is energy property eligible for the credit, but guidance on this issue from Treasury would be helpful.

C. Phaseout of Direct Payment.

1. For the Code § 45 PTC and Code § 48 ITC, as well as the Code § 45Y PTC and Code § 48E ITC that come into effect in 2025, the direct payment phases out beginning in 2024 unless certain domestic content (US produced iron, steel, and manufactured components) requirements are met or an exception applies.

2. If the domestic content requirements are not met, the phaseout generally reduces the direct payment by 10% for projects beginning construction in 2024, 15% for projects beginning construction in 2025, and by 100% for projects beginning construction in 2026.

3. Guidance, to be provided by Treasury, will provide two exceptions, and if either is met then there is no reduction in the amount of the direct payment of the tax credit:

a) If the inclusion of steel, iron or manufactured products produced in the United States will increase the overall costs of construction of qualified facilities by more than 25%, or

b) Relevant steel, iron or manufactured products are not produced in the United States in sufficient and reasonably available quantities or of a satisfactory quality.

D. Bond Counsel and Tax Credits.

1. It seems likely that smaller tax-exempt borrowers are likely to turn to bond counsel for advice on receiving payments pursuant to Code § 6417. For example, the local government that installs a solar project for $200,000 is unlikely to receive the specialist attention that might be afforded a $20 million utility scale solar project.

2. For an excellent – and user friendly – write-up of the federal energy business tax credit rules see https://www.energy.gov/eere/solar/federal-solar-tax-credits-businesses.

3. As in the case of private developers, in many cases (e.g., solar electric and wind) tax-exempt borrowers installing credit eligible energy facilities will have a choice between electing to use ITC or PTC. That choice will boil down to two basic issues: how much credit will be generated (e.g., 30% of cost vs present value of annual credit equal to, e.g., 2.6 cents/KWh times number of KWh/year for 10 years) and expected timing of receipt.