

**NATIONAL ASSOCIATION OF BOND LAWYERS**  
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**Recent Trends in Energy Finance**

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On this panel, we will discuss two major recent developments in energy finance.

First, the number of tax-exempt electric and gas prepayment transactions has increased dramatically over the past five years due to structural innovations in the market and rising interest rates. Prepayment transactions afford municipal utilities the ability to make long-term purchases of gas or electricity at a discount to the applicable index price. You might be thinking: “Aren’t there complicated tax rules that make it difficult to finance the prepayment of expenditures on tax-exempt basis?” Indeed. We will provide an overview of the structures of these transactions and the tax laws that make them possible.

Second, the Inflation Reduction Act of 2022 (the “IRA”) created new opportunities for entities that aren’t subject to federal income tax, such as governmental entities and municipal utilities, to participate in the benefits of various energy tax credits even though they don’t pay federal tax by allowing these entities to receive cash payments in lieu of the tax credits. The U.S. Treasury and the Internal Revenue Service (“IRS”) have been releasing guidance on these provisions since late 2022, and more is to come. This outline will address certain of the key provisions of the IRA that allow tax-exempt entities to receive cash instead of tax credits.

# I. PREPAYMENT TRANSACTIONS

## A. INTRODUCTION

Prepayment transactions allow municipal utilities to issue tax-exempt bonds and use the proceeds to prepay the cost of long-term future purchases of natural gas or electricity at prices below the applicable market price. Specifically, if a municipal utility enters into a commodity purchase agreement where it reasonably expects to purchase the prepaid gas or electricity during the term of the agreement and expects to use the gas or electricity for qualifying uses, the utility can use the proceeds of tax-exempt bonds to prepay a commodity supplier for a fixed amount of gas or electricity.<sup>1</sup>

Tax-exempt prepayment transactions can generate a discount of 5-10% off of the forward price of natural gas or electricity for a municipal utility and are structured to be non-recourse to the municipal utility. They are highly structured financings requiring the performance of numerous parties and certain structural features to insulate bondholders from the risks in the transaction from non-performance of such parties. The credit ratings of the various parties are important because ratings on prepayment bonds are based on the “weak-link” approach, meaning that the rating of the transaction will either be higher than or equal to the weakest credit involved in the transaction, depending on the size of the weakest credit and the amount of the credit enhancement of higher-rated credits among the underlying obligors.<sup>2</sup>

Most of the early transactions completed between 2003 and 2008 were for the prepayment of natural gas, and the gas supplier was usually the commodity unit of a large bank or investment bank. The same bank or investment bank would guarantee the performance by the supplier unit, allowing the bonds to have the same (stronger) credit rating as the bank providing the guarantee. A number of electricity prepayment deals were also done around this time using the gas prepayment structure. These prepayment transactions provided municipal utilities with several significant benefits in addition to the expected cost savings over the life of the transaction, including that the municipal utility generally had to pay only for the gas or electricity that was actually delivered, and the bonds were excluded from the municipal utility’s debt metrics.

These early gas prepayment transactions were typically funded by an upfront payment from the issuer for the twenty to thirty-year term of the transaction. The amount of this payment was based on the gas price curve. The bonds were fixed-rate bonds issued by a municipal issuer, often a special purpose entity created for the prepayment transaction. There was a fixed discount to the monthly index prices for the term of the transaction. Between 2008 and 2012, a few prepayment transactions were executed, which were funded with the proceeds of variable rate demand bonds

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<sup>1</sup> Although not discussed in this outline, a number of prepayments for natural gas were completed in the 1990s. Several of those transactions were audited by the IRS. Although those audits were closed without change, the IRS revised the Treasury Regulations in 2003, and the Internal Revenue Code (the “Code”) was subsequently amended to permit prepayments for natural gas and electricity under specific sets of rules.

<sup>2</sup> See Fitch Ratings, U.S. Public Finance Prepaid Energy Transaction Rating Criteria, June 13, 2023 (<https://www.fitchratings.com/research/us-public-finance/us-public-finance-prepaid-energy-transaction-rating-criteria-13-06-2023>) and Moody’s Investors Service, US Gas Prepayment Bonds Methodology, July 1, 2019 (<https://ratings.moody.com/api/rmc-documents/60900>).

that were supported by a direct-pay letter of credit and swapped to a fixed rate of interest through an interest rate swap agreement.

The volume of prepayment transaction deals slowed significantly between 2009 and 2016 due to interest rates. Many of the outstanding prepayment bonds at this time suffered credit downgrades due to the downgrades of the ratings of the banks and investment banks.

The original natural gas transaction structures have evolved in the last few years to address the changing needs of municipal utilities and lessons learned from the impact of the credit crisis on the economics of these transactions. Transactions beginning in 2016 have been executed with a segmented structure under which the interest rate on the bonds is reset periodically after the initial rate period and bonds are remarketed when the interest rates are reset.

As renewable energy resources have become important in future resource planning for municipal utilities, some transactions now provide the municipal utility with the ability to designate whether to receive deliveries of an equal value of natural gas or electricity or renewable natural gas during the term of the transaction. Prepayment transactions solely for renewable energy have also become common.

## **B. PREPAYMENT STRUCTURES**

### **1. Prepayments Transactions Generally**

In a modern prepayment transaction, a municipal conduit issuer issues tax-exempt bonds on behalf of one or more municipal gas or electric utilities to prepay for a future supply of natural gas or energy at a discounted price to be delivered over a twenty to thirty-year period. The issuer of the tax-exempt bonds pays the bond proceeds to a gas or energy supplier in exchange for the delivery of gas or energy over the life of the bonds pursuant to a commodity purchase agreement (“Prepaid Commodity Purchase Agreement”). The supplier of the gas or electricity (the “Commodity Supplier”) is usually, but not always, a commodity-trading subsidiary of an investment bank. The municipal issuer sells the gas or energy it purchases under the Prepaid Commodity Purchase Agreement to one or more municipal gas or electric utilities (each a “Participant” and collectively, the “Participants”) at a discount to first-of-the-month market prices through individual supply agreements. The price paid by the Participants under the supply agreements is equal to the monthly index price minus the discount. The Participants then distribute the gas or electricity within their systems to their customers as required by the tax regulations governing prepayment transactions.

As highly structured financings, the municipal conduit issuer depends on the performance of a number of different parties to pay principal and interest to bondholders. The transactions are typically structured so that there are sufficient funds on hand for the issuer to make debt service payments regardless of movements in gas prices, provided that all parties to the transaction perform in accordance with the terms of the transaction documents. If an issuer does not receive sufficient payment from any one of the transaction parties, and there is no alternative source of available funds to cover the nonpayment, there may not be enough funds to pay debt service. As a result, the transactions are structured with a number of features intended to protect the bondholders.

## **2. Parties to a Prepayment Transaction**

The parties involved in a prepayment transaction generally include the following:

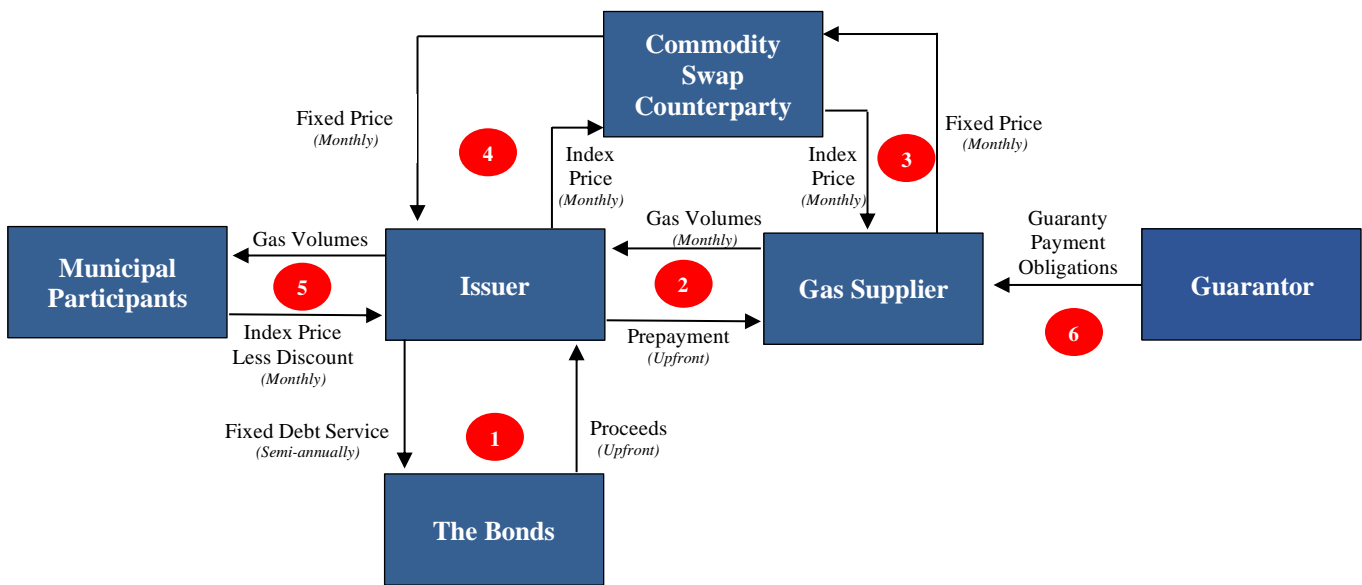
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| <b><i>Issuer:</i></b>                          | A political subdivision or other state or local governmental entity with the authority under state or local law to issue tax-exempt bonds to finance the acquisition of long-term natural gas or electricity supplies. This may be a special purpose entity whose primary purpose is to enter into and manage transactions of this type on behalf of member municipal utilities. This issuer often has limited assets of its own and functions like a conduit issuer.   |
| <b><i>Commodity Supplier:</i></b>              | The entity, typically a commodity-trading entity affiliated with a bank or investment bank, responsible for delivery of the prepaid gas or electricity to the specified delivery points and for making payments in the event of undelivered prepaid gas or electricity (subject to force majeure) and for the remarketing to qualified users of the prepaid gas or electricity at the request or direction of the Issuer or the Participants. The Commodity Supplier is also responsible for making any termination payment resulting from a termination of the Prepaid Commodity Purchase Agreement. |
| <b><i>Participants:</i></b>                    | Any electric and natural gas utility system that is owned by a state or local government and which is duly authorized under applicable state law to participate in the prepayment transaction and satisfy the requirements of the Internal Revenue Code (the “Code”) and Treasury Regulations thereunder (the “Regulations”). The Participants in a prepayment transaction are the ultimate purchasers of the supply of gas and/or electricity.   |
| <b><i>Guarantor of Commodity Supplier:</i></b> | A third party, typically the parent company of the Commodity Supplier, who agrees to guaranty the Commodity Supplier’s on-going payment obligations under the Prepaid Commodity Purchase Agreement, including any termination payment.  |
| <b><i>Trustee:</i></b>                         | A financial institution with requisite trust powers to serve as trustee for the bonds (the “Prepay Bonds”) under the Trust or Bond Indenture.   |
| <b><i>Interest Rate Swap Provider:</i></b>     | For prepayment transactions that use variable rate bonds, the entity with whom the Issuer enters into an interest rate swap agreement to swap the fixed payment received under the commodity swap into a floating-rate to pay the floating-rate debt service on the Prepay Bonds.   |
| <b><i>Commodity Swap Counterparty:</i></b>     | The entity which enters into a matching commodity swap agreements with the Issuer (the “front-end swap”) and with the Commodity Supplier (the “back-end swap”).   |

### 3. Prepayment Structures

#### a. *Full Term Prepayment Structures*

Early gas prepayment transactions that were done in the 2003-2008 timeframe were typically funded by an upfront payment in amount of the gas to be purchased over a twenty to thirty-year period with the proceeds of fixed-rate bonds. There was a fixed discount to the variable monthly index prices for gas for the entire twenty to thirty-year term. A diagram and description of the key provisions of a fully funded prepayment structure is set forth below:

**Prepaid Natural Gas Structure**  
(Fixed Rate Bonds)



The numbered paragraphs set forth below relate to the numbers shown in the preceding chart:

(1) The issuer issues fixed-rate bonds to fund the prepayment for natural gas and to pay financing costs and fund certain reserve funds.

(2) The issuer transfers the bond proceeds to the gas supplier to prepay the supplier for a fixed amount of natural gas to be delivered over twenty to thirty years. Under a prepaid natural gas sales agreement, the gas supplier will be obligated to (a) deliver specified daily quantities of gas each month to the issuer for twenty to thirty years; (b) make payments for any gas not delivered based on replacement cost or the monthly market index price, whichever is higher; and (c) make a termination payment upon any early termination of the prepaid natural gas sales agreement.

(3) The gas supplier enters into a commodity swap with the commodity swap counterparty to facilitate its ability to purchase at market prices the specified gas

volumes required to be delivered each month throughout the term of the prepaid natural gas sales agreement.

(4) The issuer enters into a commodity swap with the commodity swap counterparty (“Issuer Commodity Swap”), creating the economic effect of fixing the discount below the market price at which gas is sold to the Participants under gas supply contracts. The Issuer Commodity Swap enables the Issuer to sell prepaid volumes to the Participants at discounted monthly prices while ensuring that the net funds from Participant payments and the swap always equal or exceed debt service regardless of the price of natural gas at the time. Volumes, term, pipelines, and delivery points for the Issuer Commodity Swap mirror those of the swap between the same counterparty and the gas supplier (the “Gas Supplier Commodity Swap”). In the event of an early termination of the prepayment transaction, under the circumstances permitted by the IRS the swaps will terminate with no termination payment required.

(5) Under the gas supply contracts, the issuer has agreed to sell to the participants 100% of the gas delivered by the gas supplier on a pay-as-you-go basis at a price equal to the applicable monthly market index less a discount determined to ensure that the month’s net proceeds under the gas supply contract (net of swap payments and receipts and investment income from the debt service account) will enable the issuer to make scheduled deposits to pay debt service.

(6) The payment obligations of the gas supplier are unconditionally and irrevocably guaranteed by its parent company and provides a higher rating for the transaction and increasing the discount.

The cumulative effect of the structure described above is to ensure that the issuer receives dependable natural gas supplies at a discount below current market prices and the resulting monthly net revenues, regardless of fluctuations in gas prices, are adequate, together with investment income on amounts deposited under the bond indenture, to pay the debt service requirements on the bonds and on-going fees and expenses when due. The terms of the documents were drafted to mitigate certain risks, including, among others, a failure of the gas supplier to deliver gas, a failure of the municipal issuer to take delivery of the prepaid gas, a failure by the participants to take and pay for the gas, a failure by a swap counterparty to make a required payment, the occurrence of a force majeure event that would prevent delivery or receipt of the prepaid gas, or failure of the bonds to qualify as tax-exempt debt.

A handful of prepayment transactions were executed that were funded with the proceeds of variable rate demand supported by a direct-pay letter of credit and swapped to a fixed rate of interest.

### ***b. Segmented Prepayment Structures***

As described above, the early prepayment transactions were typically long-term fixed-rate bond transactions and the savings (the amount of the discount to the index price) was locked in for the term of the transaction. As a result of changing interest rate environments, prepayment structures have been developed that included bonds with interest rate resets and mandatory tender provisions after a period of five to seven years, breaking the interest rate periods over the life of

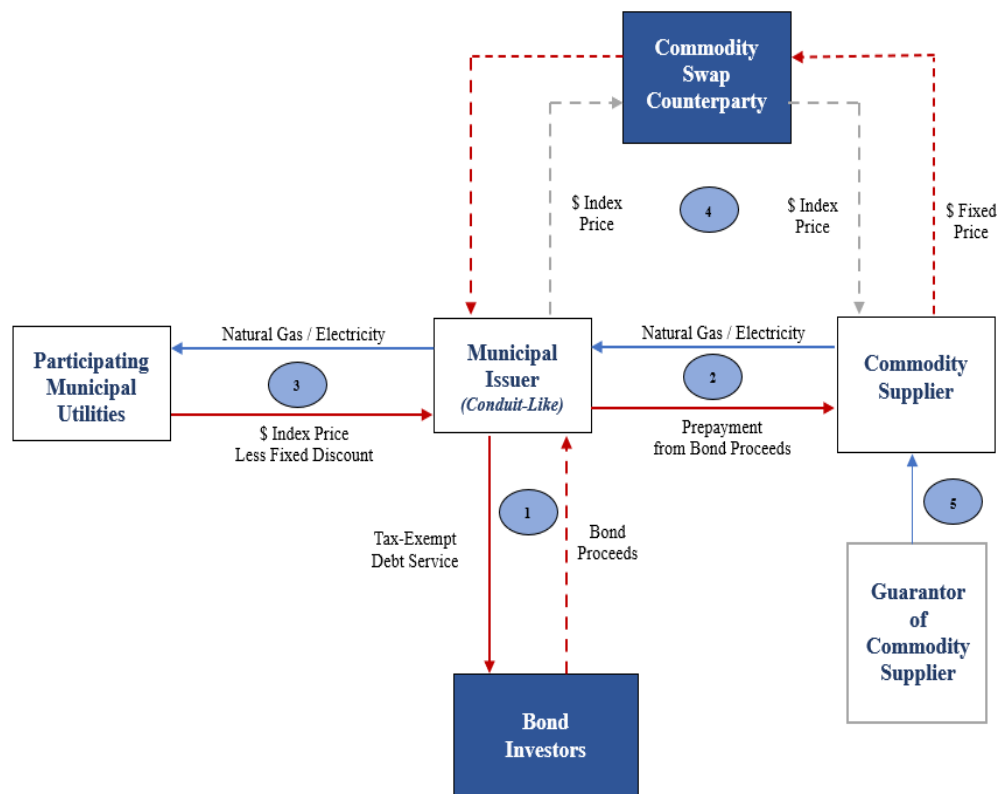
the bonds into different “segments.” While the municipal issuer and participants still enter into long-term commodity purchase and sale agreements, the interest rate on the bonds and the commodity price are reset at the end of each period through a remarketing process to maximize the savings from the transaction and to create the opportunity for improved overall savings going forward. The Issuer and the Commodity Supplier will enter into an agreement that establishes the procedures for the determining the interest rates on the Prepay Bonds for the future interest rate periods or “segments” during the twenty to thirty-year term of the prepayment transaction after the initial interest rate period for the Prepay Bonds ends as well as for setting the discount and the resulting savings for the Participants for such future interest rate periods. This structure has been used to prepay for gas or electricity (including renewable energy) or gas switching to electricity.

### *c. Innovations in Prepayment Structures*

Prepayment transactions in recent years have further evolved to address the increasing importance of renewable energy resources in the future resource planning of municipal utilities. The structure of the prepayment transactions for renewable energy remains similar to the structures for natural gas prepayments with some modifications to address differences between natural gas and renewable energy supplies, including the use of a utility’s existing power purchase agreements for renewable energy as part of the prepayment transaction. As a result, the Commodity Supplier will acquire all or a portion of the renewable energy supply to be delivered under the prepay transaction through an assignment or novation of certain of the Participants’ existing power purchase agreements (“PPAs”). As renewable energy resources have become important in future resource planning for municipal utilities, some transactions now provide the participant with an opportunity to switch the natural gas deliveries to the delivery of an equal value of electricity or renewable natural gas during the term of the transaction so that the cashflows remain unharmed. This provision allows a municipal utility to prepay for seven to ten years of natural gas today and then electricity for the subsequent reset periods thereafter.

### C. KEY DOCUMENTS IN A PREPAYMENT TRANSACTION

As described above, a municipal prepayment transaction structure involves a number of contractual undertakings among the parties. As shown in the diagram above, there are four contractual relationships and documents common to almost every prepayment transaction and provide the basic underlying framework for these financing structures.



The numbered paragraphs set forth below relate to the numbers shown in the preceding chart and identify and describe the key documents in a prepayment transaction. They are as follows:

(1) *The Trust or Bond Indenture.* The municipal entity that issues the tax-exempt prepayment bonds (the “Issuer”) will issue the Prepay Bonds pursuant to the terms of a trust or bond indenture (the “Indenture”). The Indenture sets forth the terms of the Prepay Bonds and conditions for the issuance of additional bonds and refunding bonds. The Indenture also establishes the trust estate and the funds and accounts that will secure the payment of debt service on bonds and the commodity swap payments, including redemption of the Prepay Bonds prior to maturity or mandatory tender if required due to an early termination of the prepay transaction. The Indenture also appoints a trustee with requisite trust powers to serve as trustee for the Prepay Bonds under the Indenture and to hold and administer the trust estate established for the Prepay Bonds.

(2) *The Prepaid Commodity Purchase Agreement.* This agreement is between the Issuer and the Commodity Supplier and establishes the terms and amount of the prepayment (the “Prepayment”) to be made by the Issuer to the Commodity Supplier, payable from the Prepay



Bond proceeds, for delivery and taking of natural gas and/or electricity by Issuer from the Commodity Supplier for a twenty to thirty-year delivery period.

(3) *The Commodity Supply Agreement.* Under the Commodity Supply Agreement, each municipal utility (“Participant”) agrees to purchase, and the Issuer agrees to deliver and sell at a floating price that includes a fixed discount, all or a portion (depending on the number of Participants in a particular transaction) of the natural gas and/or electricity that the Issuer acquires under the terms of the Prepaid Commodity Purchase Agreement. If the Participant cannot take the natural gas or electricity that it agreed to purchase (for example, because of loss of load on its utility system or adverse changes of law, among other reasons), the Participant may remarket, request the Issuer to remarket, or arrange with the Commodity Supplier to remarket such commodities. In order to maintain the tax-exempt status on the Issuer’s Prepay Bonds, the Participant covenants to sell or use commodities only for a “qualifying use” consistent with IRS regulations.

The Participant’s payments for the commodities are payable from revenues as an operating expense of the Participants’ municipal utility system. While the payments received by the Issuer from the Participant in accordance with the terms of the Commodity Supply Agreement are “revenues” for the purpose of the Indenture and will be deposited by the Issuer with the trustee and used to pay debt service on the Prepay Bonds, the Participant has no obligation to pay debt service on the Prepay Bonds.

(4) *The Commodity Swap Agreements.* As described above, the Commodity Supplier, the Issuer, and the Participant each seek a price for the gas or electricity (each a “commodity”) based on current prices (e.g., index prices for gas). Because the price paid under Prepaid Commodity Supply Agreement is based on a fixed price for the applicable commodity, a mechanism is needed to convert the price to a variable, market-based price. Therefore, the Issuer will enter into a floating-to-fixed commodity swap with a swap provider (the “Commodity Swap Provider”) to receive a fixed payment while it pays the monthly market price (the “Issuer Commodity Swap”) and the Commodity Supplier and the Commodity Swap Provider will also enter into a swap (the “Supplier Commodity Swap”) pursuant to which the Commodity Swap Provider will be required to pay a floating amount each month and the Commodity Supplier will be required to pay a fixed amount each month. Volumes, term and delivery points for the Supplier Commodity Swap mirror those of the Issuer Commodity Swap.

Under the Issuer Commodity Swap, the Issuer will be required to pay a floating amount each month based on the first-of-the-month index price or prices applicable to gas or electricity at the delivery point or points for such month, and the Commodity Swap Provider will be required to pay a fixed amount each month based on the forward price or prices for such gas or electricity used to determine the amount of the Prepayment for such month.

In order for the commodity swaps to function as an effective hedge, payments from the Participant(s) must be sufficient to make the required payment by the Issuer under the Issuer Commodity Swap. The payments from the Commodity Swap Provider must be sufficient, together with interest earnings when applicable, to pay the interest and the principal due on the Prepay Bonds as well as any other transaction expenses.

(5) *The Guarantee.* The payment obligations of the Commodity Supplier are usually guaranteed by a parent or affiliate of the Commodity Supplier. The payment obligations of the Commodity Supplier may include payments under the Prepaid Commodity Sales Agreement (e.g., obligation to make payments upon failure to deliver commodities, obligation to make a termination payment), the obligation to purchase certain receivables of the Issuer, and obligation to make interest rate swap payments if an interest rate swap is used. Guarantee obligations are usually capped at a specified amount. It is important to note that the guarantee is a guarantee only of the Commodity Supplier's payment obligations under various transaction documents, and not a guarantee to deliver commodities, and is not a guarantee to pay debt service on the Prepay Bonds.

#### **D. TAX CONSIDERATIONS FOR PREPAYMENT TRANSACTIONS**

In general, the use of tax-exempt bond proceeds to prepay an expense is often treated as the acquisition of investment property rather than an expenditure of bond proceeds.<sup>3</sup> In other words, in that situation, the prepayment would be treated as an investment of bond proceeds that the issuer has to continue to monitor to determine whether it complies with the applicable arbitrage yield restriction and rebate requirements. (This will often mean that the prepayment simply can't be financed with tax-exempt bonds.) There are certain exceptions to this general rule, however. The rules regarding Prepay Bonds are an example of such an exception.

In August of 2003, the IRS released final regulations (the "2003 Final Regulations") relating to the application of the arbitrage rules to prepayments for natural gas and electricity.<sup>4</sup> These regulations confirmed that a prepayment for natural gas won't be treated as investment property as long as the municipal utility uses at least 90% of the gas to supply retail customers in its historic service territory or to make wholesale sales to other municipal utilities that use the gas to supply their own retail loads. A utility's historic service territory is the area it served at all times during the five years leading up to when the tax-exempt bonds were issued.

The 2003 Final Regulations also effectively extended the rules for prepayments for natural gas to prepayments for electric capacity or energy by permitting prepayments to purchase a supply of electricity provided that at least 90% of the electricity is consumed in the municipal utility's service area. The definition of service area for electric utilities is the same as for gas utilities. In addition, the IRS eliminated the requirement that the service area include only areas in which the utility has an obligation to serve its customers. For purposes of the 90% test, qualifying sales of electricity are defined as electricity: (i) furnished to retail customers of the issuing municipal utility located in its service area; and (ii) sold to a governmental utility and furnished to retail customers in the service area of the purchaser.

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<sup>3</sup> See Code Section 148(b)(1) (providing that "higher yielding investments" means "any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue"); Code Section 148(b)(2)(D) (providing that "investment property" includes "investment-type property"); Treas. Reg. Section 1.148-1(e)(2)(i) ("Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.").

<sup>4</sup> See Treas. Reg. Section 1.148-1(e)(2)(iii).

The 2003 Final Regulations were followed by the Energy Policy Act of 2005 (the “2005 Act”) which provides a safe harbor from arbitrage restrictions under Section 148 of the Internal Revenue Code for prepayments for natural gas that are part of a qualified natural gas supply contract.<sup>5</sup> The 2005 Act also provides that such prepayments are not treated as private loans for purposes of the private business tests.

Section 1327 of the 2005 Act<sup>6</sup> creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate arbitrage restrictions. The term “investment type property” does not include a prepayment under a “qualified natural gas supply contract.” Section 1327(b) provides that such prepayments are not treated as private loans for purposes of the private business tests. Thus, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility would not be treated as the acquisition of investment-type property. The safe harbor provisions do not apply if the utility engages in intentional acts to render the volume of natural gas covered by the prepayment to be in excess of that needed (a) for retail natural gas consumption and (b) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility.

Sizing limitation. The 2003 Final Regulations apply the 90% sizing limitation on an aggregate basis over the term of the bond issue that financed the prepayment and require that the issuer monitor the amount of gas or electricity sold outside its service area. The application of this limitation over the term of the bonds permits issuers to average years in which significant amounts are sold off system with years in which on system sales exceed the average. Since, however, the greatest amount to be purchased in a year is likely not to exceed approximately 110% of expected use within the service area, this is the maximum amount that could be averaged with years in which significant amounts were sold off system.

Requirement to redeem or defease bonds. To the extent that the 90% requirement is not satisfied over the term of the bonds, the issuer and the participant must take a qualifying remedial action to cure this violation. Qualifying remedial action is for the issuer to use its revenues or taxable debt to redeem or defease the portion of the bonds that corresponds to the excess gas or electricity sold outside its service area to the first call date for the bonds. In addition, the 2003 Final Regulations also provide that a qualifying remedial action includes using the cash sale proceeds received from nonqualifying sales of gas or electricity for a purpose for which the issuer could have issued tax-exempt bonds. Under this rule, an issuer could use the cash from “off-system” sales in excess of the 10% limit to finance capital improvements to its system (in lieu of redeeming bonds).

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<sup>5</sup> Unless indicated otherwise, all section references for tax matters are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. Section” references are to the Treasury Regulations promulgated under the Code.

<sup>6</sup> Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).

## **E. SECURITIES LAW ISSUES IN PREPAYMENT TRANSACTIONS**

### **1. Exemption from Registration**

The Securities Act of 1933 (the “1933 Act”) governs the primary offering of securities and requires registration of securities with the Securities and Exchange Commission (the “SEC”) unless such securities are specifically exempt from registration.

Most municipal securities are not registered with the SEC because they are “exempt securities.” Section 3(a)(2) of the 1933 Act exempts from the registration requirement any security “issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of one or more states or territories.”<sup>7</sup>

However, also subject to registration are what are known as “separate securities” which are instruments embedded in, or related to, the financing structure for an issue of municipal securities, and may, in and of themselves, be a “security” for purposes of the 1933 Act and subject to registration. Under SEC Rule 131, “[a]ny part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in section 3(a)(2) of the Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate security within the meaning of section 2(l) of the 1933 Act, issued by the lessee or obligor under the lease, sale or loan arrangement.”<sup>8</sup>

In order for a security to constitute a “separate security” under Rule 131, the instrument generally needs to form “part of the obligation” represented by the municipal bonds. Prepayment transactions involve a more complex analysis of “separate security” considerations than most municipal bond transactions. The transaction is carefully structured to ensure that any instruments do not consist of “separate securities.” This analysis will need to be undertaken by counsel on these transactions to confirm that the applicable contracts, considered individually and considered collectively, do not constitute a “security” within the meaning of the 1933 Act or a “separate security” within the meaning of Rule 131.<sup>9</sup>

### **2. Disclosure Considerations**

The offering document for the Prepay Bonds should clearly identify the amounts that are pledged to pay debt service and the structure of the transaction clearly and in a way that will not be subject to misinterpretation, including that only the Issuer is obligated to pay debt service on the bonds. Careful consideration should be given to the drafting of a “risk factors” or “investment considerations” section. As highly structured transactions, the Prepay Bonds do not have recourse to an ongoing operating fund and thus the transaction will contain numerous potential structural vulnerabilities that should be fully disclosed to investors. Careful review and consideration should

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<sup>7</sup> Securities Act of 1933, 15 U.S.C. § 77a.

<sup>8</sup> 17 CFR Sec. 230.131(a).

<sup>9</sup> For additional information, see Fippinger, The Securities Law of Public Finance, (3rd ed. vol. I Practising Law Institute, NY 2011), § 2:7.2[B] at 2-104 to 2-106.

be given to disclosure of the events and conditions in a particular prepayment transaction that could result in a failure to pay debt service on the Prepay Bonds, an early termination of the transaction leading to a mandatory redemption of the Prepay Bonds or the loss of tax exemption on the Prepay Bonds.

The offering document for the Prepay Bonds will contain financial and operating data relating to the Participants and the continuing disclosure undertaking of the issuer will provide that annual financial and operating data and event notices with respect to the Participants will be filed on EMMA. To make certain that the issuer of the Prepay Bonds can obtain the information required to maintain compliance with the continuing disclosure undertaking there is a provision in the Commodity Supply Agreement requiring the Participant to provide to Issuer: (a) such financial and operating information as may be requested by Issuer, including a Participant's most recent audited financial statements, for use in Issuer's offering documents for the bonds; and (b) annual updates to such information and statements to enable the underwriters of the offerings of the bonds to comply with the continuing disclosure provisions of the SEC's Rule 15(c)2-12. Failure by the Participant to comply with its agreement to provide such annual updates is not a default but provides the Issuer or bondholder with the ability to take such actions and to initiate such proceedings as may be necessary and appropriate to cause the Participant to comply with such agreement.

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## II. INFLATION REDUCTION ACT

### A. INTRODUCTION

On August 16, 2022, President Biden signed into law HR 5376, the Inflation Reduction Act of 2022 (the “IRA”).<sup>10</sup> The IRA, among other things, substantially expands federal tax benefits and subsidies for energy projects. For example, it extends or increases a number of existing tax credits for renewable and other green energy projects, creates new energy tax credits and creates new ways for taxpayers to monetize tax credits. The IRA has the potential to impact multiple aspects of governmental activities, such as affordable housing, nonprofits, education, transportation, and public power. The most significant aspect of the IRA for issuers of tax-exempt bonds is that it allows entities that aren’t subject to federal income tax (such as municipal utilities)<sup>11</sup> to benefit from various energy tax credits. The IRA does this by enacting Code Section 6417, which makes those credits “refundable,” which means that the tax-exempt entities who qualify will receive direct payments in lieu of tax credits.<sup>12</sup>

As further described below, the IRA extended and changed the rules for (i) the production tax credit (“PTC”) for, among other things, wind, solar, biomass facilities, geothermal facilities, and existing nuclear projects and (ii) the investment tax credit (“ITC”) for, among other things, wind, solar, stand-alone energy storage, combined heat and power (co-generation facilities), geothermal heat pumps, clean hydrogen, waste energy recovery, and biogas projects. The IRA also provides for new “technology neutral” PTCs and ITCs (which will replace the existing credits by 2025), for electric generation facilities that produce zero greenhouse gas emissions.

In addition to extending and enhancing various tax credits, the IRA fundamentally changes the way tax credits are calculated and the factors that boost the amount of the tax credit (and, thus, the amount of the direct payment for a tax-exempt entity that elects to receive it). Now tax credits start with base credit, which in some cases is 1/5 of what the tax credits were historically. That base credit may be increased by a 5X multiplier if certain “prevailing wage” requirements (under the Davis-Bacon Act) and apprenticeship requirements are met. That amount may be further increased by certain “bonuses” or “adders” to the tax credit where the project satisfies certain key goals of the IRA. For instance, if the energy project uses enough “domestic content” in its construction then there is a bonus/adder of 10%, and if the project is located in what is called an “energy community,” there is an additional bonus/adder of 10%. In addition, certain solar and wind projects located in low-income communities or tribal land may be able to receive an

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<sup>10</sup> Public Law 117-369, 136 Stat. 1818.

<sup>11</sup> This outline will refer to these entities in various places as “tax-exempt entities;” this is intended to refer to a much broader classification of entities than what might be the common usage of that term (referring to, e.g., 501(c)(3) public charities).

<sup>12</sup> A tax credit is an amount of money that a taxpayer can subtract, dollar for dollar, from the income taxes they owe, historically tax credits have had value for tax-paying organizations only to the extent the taxpayer otherwise owes federal income taxes. Since tax-exempt organizations generally do not have any federal tax liability they were not able to benefit from energy tax credits before the IRA.

additional 10% or 20% if the owner of the project applies for and is awarded that “environmental justice” bonus/adder.

In contrast, the amount of the credits is reduced by the lesser of (a) 15% and (b) the portion of the project financed with tax-exempt bonds, if the related project is financed with tax-exempt bonds. However, this 15% maximum reduction is a sharp decrease from the rule that formerly governed tax credit projects financed in part with the tax-exempt bonds, which provided for an up to 50% reduction in the amount of the credit if the property was financed with tax-exempt bonds.

You may be thinking to yourself: “Direct payments from the federal government in lieu of tax credits . . . where have I heard that before?” The direct payment provided by IRA in lieu of these various energy tax credits is governed by the same principles as the direct subsidy payment provided for Build America Bonds (“BABs”) and other direct pay bonds<sup>13</sup> under the American Recovery and Reinvestment Act of 2009.<sup>14</sup> Accordingly, it would face the same threat of reduction through budget sequestration. Importantly, the IRA provides protection for these direct payments from sequestration, which would otherwise reduce the value of the credits in the same way that it reduced the direct subsidy payment for BABs. These provisions of the IRA are described in greater detail below, although it is important to note that the new rules are complex and contain a number of additional requirements, exceptions, and limitations. This summary does not reflect the many other tax credits and energy provisions contained in the IRA, including those related to tax credits for manufacturing, energy efficiency, clean vehicles, and fuels.

## **B. OVERVIEW OF THE TAX CREDITS – PTC AND ITC**

### **1. Prior to the IRA - Power Purchase Agreements**

Prior to the enactment of the IRA, only tax-paying entities could benefit from renewable energy tax credits. Tax-exempt entities would enter into an agreement with a tax-paying developer with the developer agreeing to construct, own and operate the project. The tax-exempt entity would agree to purchase energy at an agreed-upon rate over the term (e.g., fifteen to twenty years), which would generally be adjusted annually for inflation. The developer receives several incentives, including a PTC or an ITC as well as the benefit of accelerated depreciation of the asset as the tax owner of the facility. The developer would embed some of these incentives into the contracted cost of energy and the tax-exempt entities’ cost of energy would also reflect the developer’s investment return objectives.

However, while these structures result in savings for the tax-exempt entities, there are tax consequences and other issues requiring careful consideration with these structures. Tax-exempt proceeds can only be used to make the fixed-price prepayment for the fixed amount of energy. Use of the prepaid energy is limited to retail use through government-owned utilities/customers in qualified service areas. Also, the term of the power purchase agreement cannot exceed 80% of the estimated life of the facility. The municipal utility cannot control operations of the facility, has no right of foreclosure for a breach by the developer and any purchase option for the facility must be a fair market value at the time of exercise of the option. Further, any tax-exempt bonds issued to

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<sup>13</sup> Code Section 6431.

<sup>14</sup> Public Law 111-5 (Feb. 17, 2009).

acquire the facility would need to obtain volume cap in accordance with Section 141(d)(2) which defines “nongovernmental output property” generally as any property (or interest therein) that before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (within the meaning of § 141(b)(4)) (other than a facility for the furnishing of water).

With the enactment of the IRA, private ownership of renewable energy projects is no longer necessary for local governments to obtain any benefit from available federal tax credits -- local governments can now own renewable energy projects and finance them with tax-exempt bonds and receive direct payments of in lieu of tax credits.

## **2. Production Tax Credit (“PTC”)**

PTCs are provided for under Code Section 45.<sup>15</sup> The PTC is a per-kilowatt-hour (“kWh”) credit for producing energy from a qualifying resource. The PTC is paid over the ten-year period beginning on the date the facility is placed in service. The amount of the “base” credit is 0.3 cents per kWh but is indexed for inflation so that the rate for 2022 is 0.52 cents per kWh. The credit increases to 1.5 cents per kWh, 2.6 cents per kWh as adjusted for inflation for 2022 if the prevailing wage and apprenticeship requirements described below are met or are not applicable. The rates are adjusted annually for inflation.

The types of projects eligible for the PTC are energy projects under Section 45 of the Internal Revenue Code, including those using wind, closed and open-loop biomass, solar, geothermal energy, and hydropower to generate electricity. The IRA extends to December 31, 2024, the construction start deadline for otherwise eligible projects, but these credits are to be replaced thereafter with the new “tech neutral” PTC (described below).

The IRA creates a new PTC for electricity sold after 2023 and through 2032 from existing nuclear projects that never received federal tax credits. The base credit is 0.3 cents per kWh (0.52 cents per kWh for 2022), increasing to 1.5 cents per kWh (2.6 cents per kWh for 2022) if the prevailing wage and apprenticeship requirements are met. The credit is, however, reduced by 80% of the gross receipts from sales of electricity at a price in excess of 2.5 cents per kWh.

In addition, a new PTC will apply to qualifying clean hydrogen projects. The IRA also extends and enhances the PTC for carbon sequestration projects. As with the other PTCs, there are base credit amounts for hydrogen and carbon sequestration projects and increases for projects that satisfy the prevailing wage and apprenticeship requirements and potentially additional bonus credits and requirements described in Part E below.

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<sup>15</sup> To allow for new technologies that are not currently enumerated in Section 45, beginning in 2025, the Section 45 PTC will be replaced with the “technology neutral” Section 45Y PTC. Instead of having a list of qualified technologies, credit will be based on “greenhouse gas emissions rate” that is expressed as grams of CO<sub>2</sub>e per kWh, and the IRS will publish tables showing rate for different types of facilities.



### **3. Investment Tax Credit (“ITC”)**

ITCs are provided for in Section 48 of the Code. The ITC is a one-time credit after the facility is placed in service. In contrast to the PTC, which is calculated based on the amount of energy that the project produces, the ITC is calculated based on a percentage of the *cost* of qualifying energy property. For most ITC projects the base rate is 6% and the full rate is 30% (subject to further increase by potential bonus/adders described in Part E below). The ITC vests 20% each year over 5 years.

There are two types of ITC. One is limited to certain types of energy property. The other is “technology neutral.” The types of projects eligible for the ITC are those under Section 48 of the Code, which include energy projects, which begin construction before 2025 using solar, geothermal energy, combined heat and power systems, qualified small wind projects, and waste-energy recovery, as well as those described in Section 45 (related to PTCs) that elect to take the ITC. The IRA also extends the ITC to standalone energy storage projects and certain other types of facilities. The amount of the base ITC is 6% for certain projects like solar, wind, combined heat and power (co-gen), geothermal heat pumps or energy storage. The credit increases to 30% if the prevailing wage and apprenticeship requirements described below are met or are not applicable (subject to further increase by potential bonus/adders described in Part E below).

### **4. New “Tech Neutral” ITC and PTC for Zero Emission Projects.**

The IRA creates a new ten-year PTC (Section 45Y) and an ITC (Section 48E) for property that generates electricity with a greenhouse gas emission rate of zero, and is placed in service after 2024. These credits also apply to retrofits placed in service after 2024. These credits have the same base rates as the PTCs and ITCs under Sections 45 and 48 (that is, 0.3 cents per kWh (prior to the inflation adjustment) and 6% or 2% for ITC) and the same increases for satisfaction of the prevailing wage and apprenticeship requirements, if applicable (that is, 1.5 cents per kWh (prior to the inflation adjustment) and 30%) and potential bonus credits described in Part E below.

## **C. PTC OR ITC – THAT IS THE QUESTION**

Many factors will influence whether to use the PTC or the ITC for a particular project and tax-exempt or taxable financing for a given project. A final decision on which credit is likely to apply is likely to be project- and utility-specific. The ITC is one-time tax credit that does not vary by system performance, whereas the PTC provides a cash flow, as the tax credits are earned over time. Whether to choose the ITC or the PTC depends largely on whether the facility owner will utilize the energy or if there is a third-party off-taker, the amount of renewable resources available, and whether it is eligible for any bonus tax credits. Smaller-scale photovoltaics (“PV”) projects and concentrated solar power (“CSP”) projects generally receive more value utilizing the ITC, particularly if they can utilize a low-income bonus, which is not available with a PTC. As described above, the PTC is a per-megawatt hour (“MWh”) payment based on actual production over the first ten years of project operation (adjusted each year for inflation) and payable annually

based on the preceding year's production while the ITC is a one-time payment (that vests 20% over five years), equal to a percentage of project costs, from the date the facility is placed in service.

The following chart highlights certain of the key differences between the PTC and the ITC:

| <b>Incentive Considerations</b>  | <b>Production Tax Credit (\$26.00 MWh)</b>   | <b>Investment Tax Credit (30% of qualified costs)</b>  |
|--|--|--|
| <ul style="list-style-type: none"> <li>• Can elect to take one of the incentives (not both)</li> <li>• Each project is unique in terms of which incentive and form of debt provides the highest benefit</li> </ul> | <ul style="list-style-type: none"> <li>• Incentive is based on the energy produced from the renewable facility</li> <li>• Received annually for first ten years of operation</li> <li>• Adjusted for inflation each year so maintains buying power</li> <li>• Can finance with tax-exempt debt but incentive reduced by 15%</li> <li>• Dependent upon continuing project performance and dispatch</li> <li>• Payment processing and continuing receipt of annual payments</li> <li>• Adherence to fair wage and apprenticeship requirements for ten-year period</li> </ul> | <ul style="list-style-type: none"> <li>• Incentive is based on the installed cost of the renewable energy facility</li> <li>• Received once the facility produces energy and is interconnected with the grid</li> <li>• Requires initial filing with the US Treasury and IRS (qualified costs as well as engineering reports)</li> <li>• Can finance with tax-exempt debt but incentive reduced by 15%</li> <li>• Dependent on construction completion and interconnection to grid</li> <li>• Qualifying cost calculation</li> <li>• Asset ownership versus power purchase agreement benefits</li> </ul> |

*Sources: Inflation Reduction Act, Congressional Research Service, "Tax Provisions in the Inflation Reduction Act of 2022", August 10, 2022; <https://crsreports.congress.gov/product/pdf/R/R47202>; <https://home.treasury.gov/system/files/136/Fact-Sheet-IRA-Equitable-Clean-Energy-Economy.pdf>.*

#### **D. CREDIT MULTIPLIER: PREVAILING WAGE AND APPRENTICESHIP REQUIREMENTS**

Under the IRA each of the PTCs and ITCs has a base tax credit rate that is multiplied by a factor of five if the rules related to prevailing wages and apprenticeships are satisfied or are not applicable. Importantly, the prevailing wage and apprenticeship rules apply only to projects with a capacity of at least 1 MW that begin construction sixty days after Treasury publishes guidance on these requirements, which occurred on November 30, 2022. Projects that are less than 1 MW still receive the 5x credit multiplier even if they do not satisfy the prevailing wage or apprenticeship requirements. In the event the taxpayer fails to satisfy the prevailing wage or apprenticeship requirements, the IRS provides procedures to cure the failure.

On May 12, 2023, the IRS and Treasury issued Notice 2023-38 (the "Notice"),<sup>16</sup> which provides initial guidance for developers and investors seeking to qualify projects for the domestic content bonus credit available under Sections 45, 45Y, 48, and 48E (the "Domestic Content Bonus Credit").

<sup>16</sup> IRS Notice 2023-38 (<https://www.irs.gov/pub/irs-drop/n-23-38.pdf>).

**a. Prevailing Wage**

The prevailing wage rule piggybacks off the Department of Labor’s Davis-Bacon rules and requires that laborers and mechanics are paid prevailing wages for the locality in which the project is located during the construction of a qualifying project (and, in some cases, the alteration and repair of the project) for a defined period after the project is placed into service. A prevailing wage is the combination of the basic hourly wage rate and any fringe benefits rate paid to workers in a specific classification of laborer or mechanic for all hours that work is performed in the construction, alteration, or repair on the work site of a qualified project.

For purposes of showing compliance with the IRA’s prevailing wage provisions, the tax-exempt entity must maintain records sufficient to establish that the entity and the entity's contractor and subcontractor paid wages not less than such prevailing wage rates. These records could include documentation identifying the applicable wage determination, the laborers and mechanics who performed construction work on the project, the classifications of work they performed, their hours worked in each classification and the wage rates paid for the work.

The IRA’s prevailing wage provisions became effective on January 29, 2023, so in order to receive the available enhanced tax credits for a project with a capacity of 1 MW of more, unless the project is less than 1 MW, tax-exempt entities must meet the prevailing wage requirements for facilities where construction began on or after January 29, 2023.<sup>17</sup>

**b. Apprenticeships**

The apprenticeship rule relies on the U.S. Department of Labor and state apprenticeship agencies and requires that qualified apprentices perform no less than the “applicable percentage” of total labor hours of the project. A qualified apprentice is an apprentice that participates in an apprenticeship program that is registered with the U.S. Department of Labor or a state apprenticeship agency. The applicable percentage depends on the year in which construction begins: 10% for 2022, 12.5% for 2023, and 15% thereafter. Failure to hire an apprentice is excused if there is a good faith effort to request qualified apprentices from a registered program.

The IRA’s apprenticeship provisions also became effective on January 29, 2023 (sixty days after the guidance of November 30, 2022, was published); so, in order to receive the available enhanced tax credits for a project with a capacity of 1 MW or more, unless the project is less than 1 MW, tax-exempt entities must meet the apprenticeship guidelines for projects or facilities where construction began on or after January 29, 2023.

**E. BONUS CREDITS**

**a. Domestic Content Rules**

The IRA provides that a “bonus credit” applies to a PTC or ITC facility that meets the domestic content rules. The PTC will be increased by 10%t (excluding any energy community

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<sup>17</sup> IRS Notice 2022-61; 87 FR 73580.

bonus described below under “Energy Communities” or low-income bonus described below under “Low-Income Communities”), and the ITC will be increased by ten percentage points if the prevailing wage and apprenticeship requirements described in Part D above are satisfied with respect to the facility, if applicable, and by only two percentage points if they are not. In the case of tax-exempt entities (including governmental, non-profits, tribal entities and rural electric co-ops) with projects of 1 MW or more, if the domestic content rules are not satisfied, the PTC and ITC will be reduced by 10% if construction of the facility begins in 2024, by 15% if it begins in 2025, and by 100% if construction begins after 2025. These reductions do not apply to entities that are not able to elect for direct-pay. A project that is less than 1 MW that fails to meet domestic content requirements will not lose its direct payment (it will simply not receive the 10% bonus credit for domestic content).

The domestic content rules differentiate between subcomponents and components and require that any steel, iron, or manufactured product that is part of a project is produced in the United States. The domestic content rules apply differently to two different categories of components: (a) steel or iron components, which are subject to a more stringent test, and (b) “manufactured products” (defined as any item produced as a result of a manufacturing process). Subcomponents do not need to be manufactured in the United States. For steel or iron components, the rules are satisfied with respect to a project component if all manufacturing processes with respect to the project component (other than metallurgical processes involving refinement of steel additives) take place in the United States. With respect to manufactured products, the domestic content rule is satisfied if specified percentages of the total cost of a project’s components are mined, produced, or manufactured in the United States.<sup>18</sup> The percentage is calculated by dividing the cost of all domestically manufactured products and components by the total cost of all manufactured products.

PTC and ITC projects that are 1 MW or more that started construction after 2023 must meet domestic content requirements, or be excepted from them to qualify for certain direct payments. For projects starting construction in 2024 or 2025, the otherwise-available direct payments are reduced to 90% or 85% of their value, respectively, unless the project meets or is excepted from the domestic content requirements or is less than 1 MW.

For projects 1 MW or more that begin construction after 2025, direct payments are not available unless domestic content requirements are met or an exception applies. As noted, these reductions do not apply to PTC and ITC projects with a maximum net output of less than 1 MW (AC).

The IRA directs the Treasury to provide exceptions for projects if the inclusion of US-made steel, iron, or manufactured products would increase overall construction costs by more than 25% or the relevant steel, iron or manufactured products are not produced in the United States in sufficient and reasonably available quantities or of a satisfactory quality. Additional Treasury guidance will be necessary to clarify the domestic content bonus requirements and any waiver process.

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<sup>18</sup> The percentages required are as follows: (i) 40% for projects with construction starting in or before 2024; (2) 45% for projects with construction starting in 2025; (3) 50% for projects with construction starting in 2026; (4) 55% thereafter; and (6) 20% for offshore wind in 2024, increasing to 55% by 2028.

### **b. Energy Communities**

The IRA provides a bonus credit for a PTC or ITC facility located in an “energy community” for tax credits described in the following Code sections, all as amended by the IRA: Section 45 (the current PTC) and Section 48 (the current ITC”) and their successor provisions: Section 45Y (the technology neutral PTC) and Section 48E, (the tech neutral ITC).

For the PTC, the bonus is 10% of the otherwise-applicable direct payment (excluding any domestic content or low-income bonus). For the ITC, the bonus is an additional 10 percentage points (10% adder) if the facility meets wage and apprenticeship requirements, if applicable, and only an extra two percentage points if it does not.

A project is in an energy community and eligible for the “energy communities” bonus credit if it satisfies any one of the following three tests:

- (a) ***The Brownfield Rule*** – Project is in a brownfield (as defined in §101(39)(A), (B), and (D)(ii)(III) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 U.S.C. §9601(39)), subject to certain exceptions.
- (b) ***The “MSA/NMSA Rule”*** – Project is located in one of the following:
  - (x) A metropolitan statistical area or a non-metropolitan statistical area with BOTH (a) at least .17% (that’s 1 in 600) people employed in fossil fuels and (b) an unemployment rate at or above the national average OR
  - (y) A metropolitan statistical area or a non-metropolitan statistical area with BOTH (A) more than 25% of its tax revenue derived from fossil fuel businesses and (B) an unemployment rate at or above the national average.
- (c) ***The Coal Closure Census Tract Rule*** – Project is in a census tract with a coal mine shut down after 1999 or a coal-fired electrical generator shut down after 2009 or any census tract that is adjacent to such census tract.

IRS Notice 2023-29<sup>19</sup> provided guidance on the IRA provisions relating to energy communities and provides special rules for each of the three tests set forth above, including safe harbor provisions.

### **c. Low-Income Communities**

The IRA provides potential bonus credit for a ITC facility for either a solar or wind project that has a maximum net output of less than 5 MW (as measured in alternating current) that is located in one of the following four categories and that has been allocated part of the available environmental justice solar and wind capacity limitation described below for the bonus credit:

- a. ***Category 1 – NMTC low-income community***: The facility is located in a low-income community described in under §45D(e)(1) (relating to new market tax credits (NMTCs)), with certain modifications described elsewhere in §45D(e), as any population census tract if the poverty rate for such tract is at least 20%, or, in the case of a tract not

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<sup>19</sup> IRS Notice 2023-29, April 4, 2023 (<https://www.irs.gov/pub/irs-drop/n-23-29.pdf>).

located within a metropolitan area, the median family income for such tract does not exceed 80% of statewide median family income, or in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

b. **Category 2 – Tribal lands:** The facility is located on Indian land as defined in §2601(2) of the Energy Policy Act of 1992 (25 U.S.C. 3501(2)).

c. **Category 3 – Qualified Low-Income Residential Building Project:** The facility is part of a qualified low-income residential building project if such facility is installed on a residential rental building that participates in an affordable housing program, and the financial benefits of the electricity produced by such facility are allocated equitably among the occupants of the dwelling units of such building. For a qualified low-income residential building project, §48(e)(2)(D) provides that electricity acquired at a below-market rate will be considered a financial benefit. Forthcoming guidance will further clarify the parameters of financial benefit.

An affordable housing program includes any of the following: (i) a covered housing program (as defined in § 41411(a) of the Violence Against Women Act of 1994 (34 U.S.C. 12491(a)(3)); (ii) a housing assistance program administered by the Department of Agriculture under title V of the Housing Act of 1949, (iii) a housing program administered by a tribally designated housing entity (as defined in § 4(22) of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4103(22)); and (iv) such other affordable housing programs as the Secretary of the Treasury may provide.

d. **Category 4 - Qualified Low-Income Economic Benefit Project:** The facility is part of a qualified low-income economic benefit project if at least 50% of the financial benefits of the electricity produced by such facility are provided to households with income of less than 200% of the poverty line (as defined in §36B(d)(3)(A)) applicable to a family of the size involved, or less than 80% of area median gross income (as determined under §142(d)(2)(B)). For a qualified low-income economic benefit project, §48(e)(2)(D) provides that electricity acquired at a below-market rate will be considered a financial benefit. Forthcoming guidance will further clarify the parameters of financial benefit.

**d. Environmental Justice Solar and Wind Capacity Limitation**

In order to receive the bonus credit for a solar or wind project that is less than 5 MW located in one of the four categories described above, the owner of the facility must apply for an allocation of “capacity limitation” from the Department of Treasury and the IRS (“Capacity Limitation”). For each facility owned by an applicant, the applicant may apply for an allocation of Capacity Limitation in only one category for calendar year 2023. Applicants that do not receive an allocation of Capacity Limitation will be permitted to apply for future allocations after calendar year 2023. Facilities placed in service prior to being awarded an allocation of Capacity Limitation are not eligible to receive an allocation.

## **F. ELECTRIC VEHICLES**

The IRA Section 45W created a new credit effective for “qualified commercial clean vehicles” placed in service after December 31, 2022, and before January 1, 2033. To be a qualified commercial clean vehicle, the vehicle must meet the following requirements: (a) the vehicle must be acquired for use or lease by the business; (b) the vehicle must be a depreciable asset; (c) the vehicle must be manufactured for use on streets, roads and highways or must be mobile machinery; (d) the vehicle’s battery capacity must be at least 7 kWh (15 kWh for vehicles weighing more than 14,000 pounds); (e) the vehicle must be charged by an external electricity source; and (f) the vehicle must be made by a qualified manufacturer<sup>20</sup>.

The amount of the credit is equal to the lesser of (i) 15% of the vehicle’s cost (30% for vehicles not powered by a gas or diesel engine) or (ii) the “incremental cost” of the vehicle over the cost of a comparable vehicle powered solely by a gas or diesel internal combustion engine and which is comparable in size and use. The credit is capped at a maximum credit of \$7,500 for vehicles with a gross vehicle weight rating (GVWR) of less than 14,000 pounds or \$40,000 for vehicles over 14,000 pounds.

The IRS will be tracking the credits by vehicle identification number (“VIN”) and so there is one credit available per VIN. Taxpayers seeking to claim the credit will be required to provide the VIN on the tax form used to claim the credit. In addition, once the credit has been claimed, the cost basis of the vehicle must be reduced by the amount of the credit before depreciation is taken.

## **G. DIRECT CASH PAYMENT OF CREDITS AND SEQUESTRATION PROTECTION**

### **1. Elective Direct Payments**

Historically, tax credits have only been available to entities with taxable income. A major goal of the IRA is to expand access to tax credits across sectors to the public sector, non-profits and, for some of the energy credits in some cases, taxable entities.<sup>21</sup> Now municipal public power systems (and other tax-exempt entities<sup>22</sup>) can own qualifying projects and obtain the benefit of

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<sup>20</sup> The term “qualified manufacturer” means: any “manufacturer” within the meaning of the Environmental Protection Agency’s regulations with respect to the Clean Air Act (a generally broad definition incorporating automobile manufacturers), which enters into a written agreement with the U.S. Treasury Department (Treasury Department) pursuant to which the manufacturer agrees to make periodic written reports to the Treasury Department providing vehicle identification numbers and any other required information related to each clean vehicle manufactured. A list of qualified manufacturers can be found at: <https://www.irs.gov/credits-deductions/manufacturers-for-qualified-commercial-clean-vehicle-credit>.

<sup>21</sup> The IRA also permits monetization of tax credits by taxable entities through transfer and sale under Section 6418 of the Internal Revenue Code.

<sup>22</sup> Section 6417 of the Internal Revenue Code introduces the concept of an “applicable entity,” which is an entity that is eligible to elect the direct payment of certain tax credits. In general, an applicable entity is (1) any tax-exempt organization, (2) any state or political subdivision thereof including District of Columbia or a political subdivision thereof, (3) the Tennessee Valley Authority, (4) any Indian tribal government, (5) any Alaska Native Corporation, or (6) any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas. Applicable entity includes an agency or instrumentality of any applicable entity described in clauses (2) or (4).

most of the investment and production tax credits through direct cash payments from the IRS.<sup>23</sup> The direct payment election would be available to States and political subdivisions with respect to (a) the PTCs for renewable energy projects eligible under Section 45 (as described above), and carbon sequestration, nuclear energy, and hydrogen projects, (b) the projects eligible for the ITC under Section 48, including storage (as described above), and (c) the new tech neutral ITC and PTC for zero emission energy projects. The IRA includes an anti-abuse provision under which, if Treasury determines that an excessive payment has been made, the recipient would be required repay the excess plus a 20% penalty unless a showing of “reasonable cause” is made. Taxpayers that are not applicable entities would be able to transfer specified tax credits to an unrelated party for cash, and would be eligible to elect direct payment for a limited subset of the IRA tax credits (e.g., PTCs for clean hydrogen and carbon sequestration projects). In order to be eligible for direct payments, projects must be placed in service after 2022.

Guidance issued by the IRS clarified that the direct payment rules apply to co-ownership structures commonly used in public power projects, so that two or more entities can each own a portion of a project, and their interests will be respected as separate ownership interests for purposes of the direct payment rules. The regulations also clarify that agencies and instrumentalities of political subdivisions are eligible for direct payments of credits. However, an applicable entity is not permitted to purchase a tax credit from a taxable entity and then apply for a direct payment in lieu of that credit.

## **2. Process for Receiving Direct Payments**

On June 14, 2023, the IRS released temporary and proposed regulations on direct payments, including the process for making the election for elective payments.<sup>24</sup> Taxpayers can rely on the proposed regulations for tax years beginning after December 31, 2022, as long as the proposed regulations are followed in their entirety and in a consistent manner. Under this most recent guidance, obtaining direct payments is a three-step process that begins with a project owner complying with a registration process. Registering does not guarantee eligibility for the tax credit or commit an entity to ownership of the related project or electing to receive direct payments and completing registration does not mean that the entity is eligible for the tax credit or is able to transfer or elect direct payment of the tax credit.

### **a. Registration Process Required**

The regulations state that registration is to be effectuated through an online “portal.” This portal does not exist as of yet, but the rules say that the IRS will open the portal in fall 2023. On completion of the registration process, a registration number will be provided that relates to the specific project that produces the tax credit. Each separate property that is eligible for tax credits must have a unique registration number. In addition, a registration number is valid only for

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<sup>23</sup> Section 6417 of the Internal Revenue Code permits governmental entities and tax-exempt organizations to effectively receive cash payments from the government even if the governmental entity or tax-exempt organization has no tax liability against which one of the specified tax credits can be offset.

<sup>24</sup> NABL provided comments to these regulations regarding the mechanics of the direct payment election, available here: <https://www.nabl.org/resources/comments-proposed-section-6417/>.



single taxable year and must be renewed annually. Credits cannot be claimed for a property without a registration number.

To obtain the registration number, the portal will require information about the operations of the entity and the property that will generate the credits. The regulations specify some of the required information but defer to “portal instructions” (which haven’t yet been published) any further information that could be required. The required information that the IRS has specified in the regulations includes information about the applicable entity (name, address, employer identification number, type of entity, etc.). In addition, specific information about the tax credit property must be provided, including physical location (including geographic coordinates), supporting documentation to demonstrate eligibility for the credits (such as operating permits, deeds or other evidence of ownership; etc.), the date on which construction commenced, and the placed-in-service date of the property.

In the case of production tax credits and each vesting year of an investment tax credit, the registration will have to be renewed each year (separately for each project). Again, it is difficult to know precisely what the renewal process will entail until the IRS provides more information and publishes the instructions for the online portal. The regulations also make clear that the registration will have to be updated to include any changed facts and an attestation that the facts giving rise to the credit for the particular tax year are still true.<sup>25</sup>

**b. Process and Timing for Direct Payment Claims.**

Once a registration number is obtained (and only after if it is obtained), an applicable entity can then elect to receive direct payments and submit a claim for direct payments. Both the election and the claim for direct payments are to be made on IRS Form 990-T, which is the tax return form that nonprofit corporations file with the IRS to report and pay tax on unrelated business taxable income. The IRS has not indicated whether this form will be modified to make it more user friendly for tax credits. In addition to Form 990-T, the entity must also file IRS Form 3800, the form for general business tax credits, and the form that specifically applies to the tax credit being claimed (that is, Form 3468 for the investment tax credit and Form 8835 for the production tax credit). Links to these forms are provided below.

Form 990T: <https://www.irs.gov/pub/irs-pdf/f990t.pdf>

Form 3800: <https://www.irs.gov/pub/irs-pdf/f3800.pdf>

Form 8835: <https://www.irs.gov/pub/irs-pdf/f8835.pdf>

Form 3468: <https://www.irs.gov/pub/irs-pdf/f3468.pdf>

The election to receive direct payments must be made by an applicable entity by the 15th day of the fifth month after the end of the taxable year in which the related facility is placed in service on an original return (subject to extension) and not an amended return. A governmental entity’s taxable year for this purpose is likely its fiscal year. Specifically, the rules say that the taxable year is based on its annual accounting period (that is, the annual period on which it

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<sup>25</sup> Updates to the registration are also required if, after receipt of a registration number, there are changes to the project that occur prior to filing a claim for the credit, such as a change of ownership.

computes its income in keeping its books), which would normally be the entity’s fiscal year. The rules on making the election are very strict; for example, they prohibit revoking or revising an election after it has been made. An election to receive direct payments that does not include a valid registration number for the credit property will be treated as ineffective.

The somewhat quirky way that the direct payment statute was drafted may lead to lengthy delays between the time the energy credit property is placed in service and the tax-exempt entity’s ability to claim the direct payment, particularly for facilities that are placed in service early in an entity’s fiscal year. Specifically, the theory of the direct payment is that the tax-exempt entity is treated as having made a payment of tax (which of course it did not actually make), and then the federal government “refunds” that fictional payment (leaving the tax-exempt entity richer in the amount of the payment). Because of this oddity, the fictional payment (which is then refunded in the real world) is not treated as having been made until a date that is no earlier than the due date of the tax return for the period when the credit is generated. As a result of this timing requirement, there could be a significant period of time before the tax-exempt entity can claim the direct payment, particularly for facilities placed in service early in the year.

### **3. Sequestration Protection**

The IRA provides a mechanism to prevent direct payments of tax credits from the same reductions due to sequestration that have applied to Build America Bonds and other direct pay bonds. The current sequestration rate is 5.7% and is scheduled to continue through the end of the Federal government’s 2030 fiscal year. Specifically, the IRA provides that any direct payment tax credit is automatically increased by 6.0455% and this “gross-up” mechanism will result in 100 percent of the direct pay tax credits being paid. This adjustment is fixed at 6.0455% and as long as the sequestration rate is not changed, the gross-up should protect direct payments of tax credits from being impacted by sequestration.

## **H. POTENTIAL TAX-EXEMPT FINANCING IMPLICATIONS**

A further limitation on the entities eligible to benefit from tax-exempt financing is that the tax credits are reduced if a project is financed by tax-exempt bonds by 15% or, if less than 15% of the project is tax-exempt financed, by the percentage of the project that is financed with tax-exempt bonds. This provision could encourage these tax-exempt entities to consider using taxable bonds or revenues on hand to finance all or nearly all of the cost of projects eligible for tax credits. However, under prior law, the reduction in the tax credit for projects financed with tax-exempt bonds could be up to 50%, which may encourage more of these projects to be done. Although the reduction in the credit sounds simple enough, it can raise some complicated issues, which are beyond the scope of this panel and outline, but are discussed in more detail in NABL’s comments submitted to Treasury.<sup>26</sup>

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<sup>26</sup> NABL submitted two rounds of comments on this provision and others, available here: <https://www.nabl.org/resources/response-to-irs-requests-on-ira-implementation/> (dated Nov. 4, 2022), and here: <https://www.nabl.org/resources/suppl-comments-ira-notice/> (Mar. 9, 2023).

## **I. ADDITIONAL GUIDANCE**

There are many open questions at this time as to the implementation of many provisions of the IRA for tax-exempt organizations and while a number of these tax credits have been in effect for some time with respect to other taxpayers, there are rules and procedures that still need to be adopted for tax-exempt organizations to take advantage of these new credit provisions. Treasury and the IRS have been issuing guidance on the IRA since late in 2022 but additional guidance is expected and must continue to be monitored.