Fall / Winter 2024

Elective Pay and the Transition Toward a Clean Energy Economy

Ground Rules: Disclaimer

- This deck provides an overview of certain Inflation Reduction Act tax provisions for general informational purposes only and **is not itself tax guidance**.

- The content in this presentation is based on tax guidance on IRS.gov.

- This deck relies on simplifications and generalizations to convey high-level points about Inflation Reduction Act tax provisions. Please **refer to guidance** issued by the IRS for detailed information on the rules associated with Inflation Reduction Act tax provisions.

Introduction: The Inflation Reduction Act

- The Inflation Reduction Act (IRA) makes the **largest investment in clean energy** in United States history, and much of that investment is **delivered via tax incentives**.
- The Treasury Department is the federal agency responsible for **administering the tax code** and is **proud to be playing a central role** in implementing the Inflation Reduction Act's clean energy tax incentives.
- IRA, through its clean energy tax credits, is creating jobs, lowering costs, reducing pollution and improving health outcomes.
- This presentation discusses **Elective Pay (also known as Direct Pay)**, a novel tax credit delivery mechanism created by the Inflation Reduction Act.

What is Elective Pay?

- With elective pay, tax-exempt and governmental entities that do not owe Federal income taxes are, for the first time, able to receive a **payment equal to the full value of tax credits for building qualifying clean energy projects or making qualifying investments**.
- Unlike competitive grant and loan programs, in which applicants may not receive an award, elective pay allows entities to get their payment if they meet **the requirements for both elective pay and the underlying tax credit**.

How Does Elective Pay Work?

<u>Under the final rules, applicable entities for elective pay include</u>:

- Tax-exempt organizations
  - Under final regulations, this includes any organization described in sections 501-530 of the Code that meets the requirements to be recognized as exempt from tax under those sections
- U.S. territory governments and their political subdivisions;
- States and political subdivisions, such as local governments;
- Indian tribal governments and their subdivisions;
- Agencies and instrumentalities of state, local, tribal, and territorial governments – including public utilities, school districts, public hospitals and public higher education
- Alaska Native Corporations;
- The Tennessee Valley Authority, and
- Rural electric co-operatives.

*<u>Note</u>: In general, **only "applicable entities" are eligible for Elective Pay**.*
*However, **other taxpayers** that are not "applicable entities" may elect to be treated as an applicable entity with respect to **three tax credits** (for carbon oxide sequestration, production of clean hydrogen, or advanced manufacturing).*

Applicable Tax Credits for Elective Pay

Energy Generation & Carbon Capture

Tax Provision	Description
Production Tax Credit for Electricity from Renewables (§ 45, pre-2025)	**For production of electricity from eligible renewable sources**, including wind, biomass, geothermal, solar, small irrigation, landfill and trash, hydropower, marine and hydrokinetic energy. **Credit Amount (for 2022):** 0.55 cents/kilowatt (kW); (1/2 rate for electricity produced from open loop biomass, landfill gas, and trash); 2.75 cents/kW if Prevailing Wage and Apprenticeship (PWA) rules are met [1,2,3,7]
Clean Electricity Production Tax Credit (§ 45Y, 2025 onwards)	**Technology-neutral tax credit for production of clean electricity**. Replaces § 45 for facilities that begin construction and are placed in service after 2024. **Credit Amount:** Starts in 2025, consistent with credit amounts under section 45 [1,2,3,6,7]
Investment Tax Credit for Energy Property (§ 48, pre-2025)	**For investment in renewable energy projects** including fuel cell, solar, geothermal, small wind, energy storage, biogas, microgrid controllers, and combined heat and power properties **Credit Amount:** 6% of qualified investment (basis); 30% if PWA requirements met [1,4,5,6,8]
Clean Electricity Investment Tax Credit (§ 48E, 2025 onwards)	**Technology-neutral tax credit for investment in facilities that generate clean electricity** and qualified energy storage technologies. Replaces § 48 for facilities that begin construction and are placed in service after 2024 **Credit Amount:** 6% of qualified investment (basis); 30% if PWA requirements met [1,4,5,6]
Low-Income Communities Bonus Credit (§ 48(e), 48E(h)) Application required	**Additional investment tax credit for small-scale solar and wind (§ 48(e)) or clean electricity (§48E(h)) facil-ities** (<5MW net output) on Indian land, federally subsidized housing, in low-income communities, and benefit low-income households. Allocated through an application process. **Credit Amount:** 10 or 20 percentage point increase on base investment tax credit [7]
Credit for Carbon Oxide Sequestration (§ 45Q)	**Credit for carbon dioxide sequestration** coupled with permitted end uses in the United States. **Credit Amount:** $12-36 per metric ton of qualified carbon oxide captured and sequestered, used as a tertiary injectant, or used, depending on the specified end use; $60-$180 per metric ton if PWA requirements met.[1,7]
Zero-Emission Nuclear Power Production Credit (§ 45U)	**For electricity from nuclear power facilities.** Facilities in operation prior to August 16, 2022. **Credit Amount (for 2023):** 0.3 cents/kWh (reduced rate for larger facilities); 1.5 cent/kWh if PW req's met [1,7]

* For footnotes, see irs.gov/pub/irs-pdf/p5817g.pdf. You can also learn more at IRS.gov/CleanEnergy and IRS.gov/ElectivePay.

Applicable Tax Credits for Elective Pay

	Tax Provision	Description
Manufacturing	**Advanced Energy Project Credit** (§ 48C) Application required	**For investments in advanced energy projects.** A total of $10 billion will be allocated, not less than $4 billion of which will be allocated to projects in certain energy communities. **Credit Amount:** 6% of taxpayer's qualified investment; 30% if PWA requirements are met [1]
Manufacturing	**Advanced Manufacturing Production Credit** (§ 45X)	**Production tax credit for domestic clean energy manufacturing** of components including solar and wind energy, inverters, battery components, and critical materials. **Credit Amount:** Varies by component
Vehicles	**Credit for Qualified Commercial Clean Vehicles** (§ 45W)	**For purchasers of commercial clean vehicles.** Qualifying vehicles include passenger vehicles, buses, ambulances, and certain other vehicles for use on public streets, roads, and highways. **Credit Amount:** Up to $40,000 (max $7,500 for vehicles <14,000 lbs) [9]
Vehicles	**Alternative Fuel Vehicle Refueling Property Credit** (§ 30C)	**For alternative fuel vehicle refueling and charging property**, located in low-income and non-urban areas. Qualified fuels include electricity, ethanol, natural gas, hydrogen, and biodiesel. **Credit Amount:** 6% of basis for businesses and can increase to 30% if PWA is met.
Fuels	**Clean Hydrogen Production Tax Credit** (§ 45V)	**For producing clean hydrogen** at a qualified, U.S.-based clean hydrogen production facility. **Credit Amount:** $0.60/kg multiplied by the applicable percentage (20% to 100%, depending on lifecycle green-house gas emissions), amount increases if PWA is met [1,7]
Fuels	**Clean Fuel Production Credit** (§ 45Z, 2025 onwards)	**Technology neutral tax credit for domestic production of clean transportation fuels**, including sustainable aviation fuels, beginning in 2025* **Credit Amount:** $0.20/gallon ($0.35/gal for aviation fuel) multiplied by CO2 "emissions factor"; $1.00/gallon ($1.75/gal for aviation fuel) multiplied by CO2 "emissions factor" if PWA is met [1,7]

* For footnotes, see irs.gov/pub/irs-pdf/p5817g.pdf. You can also learn more at IRS.gov/CleanEnergy and IRS.gov/ElectivePay.

Certain requirements and bonuses that may affect the amount of elective pay applicable tax credits

Prevailing Wage and Apprenticeship Requirements	For a number of the tax credits created or modified by IRA, the credit amount is increased by five times for projects that meet requirements for paying prevailing wages and using registered apprentices. On June 18, 2024, the IRS and Treasury issued final rules on bonuses related to prevailing wage and apprenticeship requirements.
Domestic Content Bonus	Projects or facilities that meet domestic content requirements are eligible for a 10 percent increase to the Production Tax Credit (sections 45, 45Y) or up to a 10 percentage point increase to the Investment Tax Credit (48, 48E). For projects or facilities beginning construction starting in 2024, for taxpayers using elective pay, the domestic content requirement can also result in a reduction of the Production Tax Credit or Investment Tax Credit if it is not met. On Dec. 28, 2023, Treasury issued guidance on this rule for projects beginning construction in 2024 (Notice 2024-9).
Energy Communities Bonus	Projects located in historical energy communities, including areas with closed coal mines or coal-fired power plants, are eligible for a 10 percent increase in the PTC and an up to 10 percentage point increase in the ITC. The bonus is also available to brownfield sites and to areas that have significant employment or local tax revenues from fossil fuels and a prior year unemployment rate at or above the national average.
Low Income Communities Bonus Credit Program	The program provides an increased credit of 10 percentage points or 20 percentage points to certain applicable credits that are part of the investment tax credit for certain facilities located in low-income communities, Indian lands, or federal housing projects, or serving low-income households. You must apply and receive a capacity allocation, and then place your facility in service to claim this bonus.

Elective Pay Potential Use Cases

Goal	Project	Relevant Tax Credits
Fleet Cost Savings	Replace existing municipal vehicle fleet with new electric vehicles and associated charging infrastructure	• Up to $7,500 per light vehicle • Up to $40,000 per larger vehicle • Up to 30% credit on investment in eligible EV charging equipment
Community Resilience	Install microgrid with solar and energy storage to serve critical infrastructure and community facilities during emergencies and grid outages	• 6% - 50% credit on investment in solar, storage and microgrid controllers
Community Heating	Develop central geothermal system to provide heating to community buildings and residential households	• 6% - 50% credit on investment in geothermal energy property

Clean Energy Investments Lower Cost

- Fleet Electrification Savings (U.S. Department of Energy)

  - EVs offer high fuel economy, which translates to lower operating costs.
  - EVs achieve their best fuel economy during stop-and-go driving conditions typical of many fleet applications.
  - Electricity prices are also less volatile than those of gasoline/diesel, making it easier to predict fuel costs over time. Lower off-peak electric rates may be available for charging, which further reduces EV fuel costs.

Clean Energy Investments Lower Cost

- Geothermal Savings (Ball State University Case Study)

  - As the coal fired boilers from the mid-20th century grew older and less efficient, Ball State University in Muncie, Indiana, grew larger. University staff needed to find a way to meet growing energy demands. Based on their research and analysis, the most cost-saving and energy-efficient solution was a campus-wide geothermal energy heating and cooling system.
  - Ball State's geothermal system heats and cools 47 buildings, covering 5.5 million square feet of space. In addition, Ball State saves approximately 45 million gallons of water, 500 billion British thermal Units (BTUs) of energy, and $2.2 - $2.5 million annually.)

Clean Energy Investments Lower Cost

- Solar Savings (San Antonio Case Study)

  - City officials plan to build and own the largest municipal onsite solar project in Texas. This $30 million project will install rooftop, parking, and park canopy solar photovoltaic systems at 42 city facilities to offset energy consumption over the long-term.
  - The projected electricity generated annually from this multi-site project is expected to offset an estimated thirteen percent of the City's electricity consumption from its buildings, which is expected to result in cumulative net financial savings between $7 - $11 million over 25 years.

Using Elective Pay with Grants and Loans

- The elective pay final rule includes a special provision that helps enable entities to **combine grants and forgivable loans with tax credits**.
- If an investment-related credit property is **funded by a tax-free grant or forgivable loan**, entities get the **same value of eligible tax credit** as if the investment were financed with **taxable funds**—provided the credit plus 'restricted tax-exempt amounts' do **not exceed** the cost of the investment.

Closing

- More Information on Direct Pay
  - ✓ IRS.gov/ElectivePay
    - ✓ Pre-filing Registration User Guide; How-to-Video
    - ✓ Permission Management User Guide
    - ✓ FAQs
  - ✓ CleanEnergy.gov/DirectPay
  - ✓ Subscribe to IRS e-News Subscriptions by visiting IRS.gov/newsroom/e-news-subscriptions → Tax exempt & government entities
- More information on the IRA
  - ✓ IRS.gov/CleanEnergy
  - ✓ www.whitehouse.gov/cleanenergy/inflation-reduction-act-guidebook/

Appendix

What if my entity co-owns applicable credit property?

Partnerships are not applicable entities under elective pay, **but many elective-pay eligible entities may want to jointly invest in clean energy projects**. For example:

- A tax-exempt entity co-investing in a clean energy project with a for-profit developer, or
- Multiple tax-exempt entities or governments that are seeking to jointly invest in clean energy projects.

Under Treasury's final elective pay rules, **if a co-ownership arrangement involving one or more elective pay-eligible entities "elects out" of partnership tax status** (meaning, elects to be excluded from subchapter K), **the applicable entities <u>can claim elective pay on tax credits earned for their share of the project</u>**.

(Cont'd) What if my entity co-owns applicable credit property?

In response to feedback that co-ownership arrangements need more clarity and flexibility to make this option feasible, Treasury proposed modifications to partnership tax rules for co-ownership arrangements eligible to elect out of partnership tax status. As finalized in November 2024, those modifications:

- **Permit clean energy investments to be made through a noncorporate entity** (e.g. an LLC), rather than requiring direct co-ownership of the property or facility by each co-owner of the property or facility. This opens up additional possible financing structures for applicable entities seeking to use elective pay through joint-ownership arrangements.
- **Modify certain joint marketing restrictions to provide that agents can enter into multi-year power purchase agreements on behalf of the owners without violating the requirements** to elect out of partnership tax status.
- When a partnership elects out of partnership tax treatment, the owners in the arrangement, including the applicable entities, can utilize **any of the IRA credits where elective pay is available** (for their share of the credits earned through the arrangement).*

Co-owners that are not eligible for elective pay (e.g., businesses that focus on jointly selling services) can generally claim tax credits against their own tax liability or utilize IRA's transferability mechanism for their share of the project.

**Note: This differs from the rules as proposed, which were limited to electricity generation.*

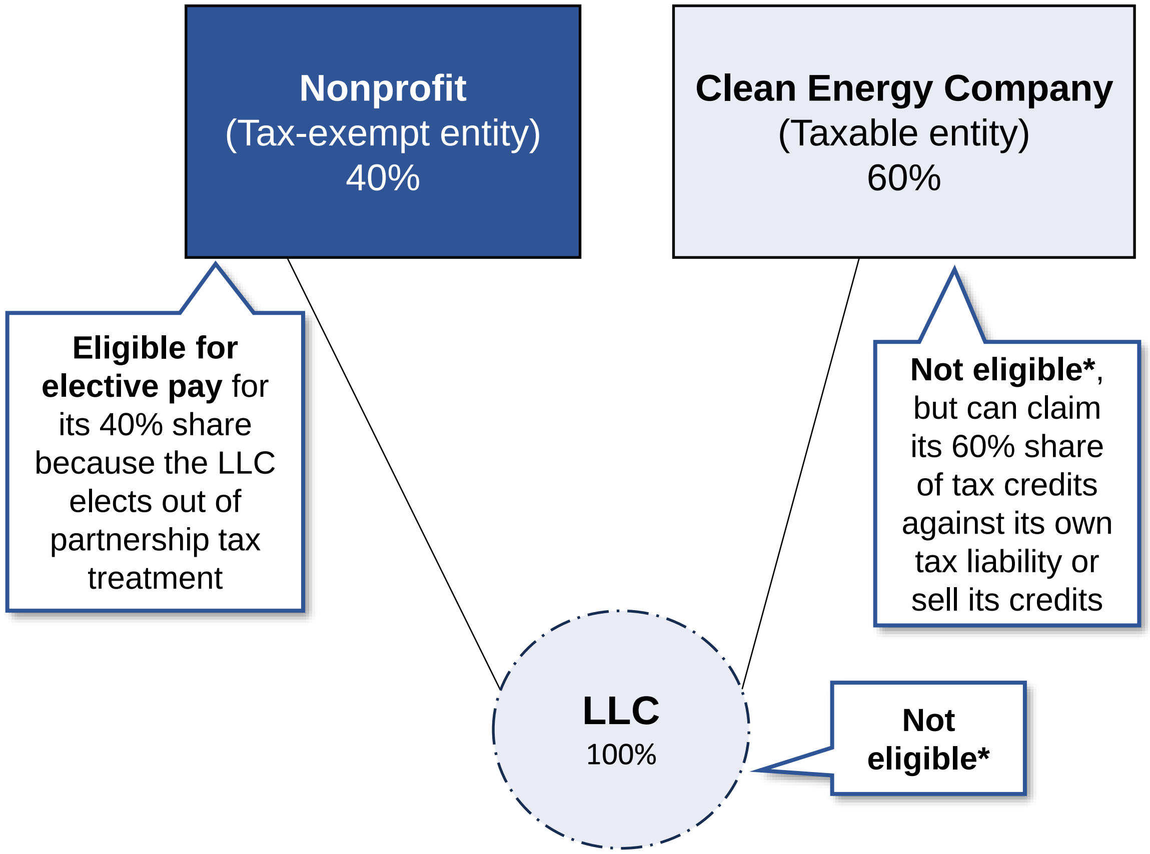
Example: Nonprofit and Business Geothermal Generation Partnership

Background:

An elective pay-eligible nonprofit and a clean energy company form an LLC and enter into a joint operating agreement to build a geothermal facility for which they intend to receive tax credits under the Production Tax Credit (§45 or §45Y).

- Under the terms of their agreement, the nonprofit owns 40% of the interest in the LLC and is entitled to 40% of the electricity produced, with the clean energy company entitled to the remaining 60%.
- The LLC makes a valid election to be excluded from subchapter K so that it is not considered a partnership for tax purposes.

Outcome: Assuming all requirements are met, the nonprofit will be entitled to 40% of the production tax credits generated by the geothermal facility and will be able to make an elective payment election for those credits.



**Note: Taxable entities and partnerships that are eligible taxpayers may make elective pay elections for certain credits (45Q, 45V, and 45X credits).*

Potential Tradeoffs When Electing Out of Partnership Tax Status

Why might a co-owned project prefer partnership tax status instead of electing out?

1. Partnerships may offer **more flexibility** to structure the economic relationship between co-owners
2. Partnerships can use transferability for eligible IRA clean energy credits (including PTCs and ITCs). **Through transferability, partnerships can effectively monetize credits sooner** than they can be paid via elective pay under the tax code.
3. Depending on circumstances, there may be practical reasons, or tax benefits such as depreciation, that might make organizing through a partnership advantageous.

The bottom line: Before entering a partnership, elective-pay eligible entities should know whether or not the partnership will be opting out of partnership tax status, how the benefits are structured, and what the organization’s tax filing obligations will be. A tax advisor may be an important resource to make those determinations.