Solar Tax Benefits Now Directly Available to State and Local Governments and 501(c)(3) Organizations

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On August 16, 2022, President Biden signed the Inflation Reduction Act (or IRA), which provides significant tax and other incentives for qualifying renewable energy facilities including solar generation facilities. Among these are the extension and creation of almost $280 billion in clean energy tax incentives as well as provisions allowing state and local governments and tax-exempt entities to receive direct benefits from such tax incentives for solar facilities owned by such entities.

Historically, owners of solar generation facilities in the United States have received federal tax credits and benefits such as investment tax credits (ITCs) and production tax credits (PTCs). However, prior to the IRA, these tax credits were being reduced or phased out. The IRA not only extends these tax credits but also expands their availability.

Direct Pay

Prior to the IRA, only taxpaying entities could take advantage of the ITCs and PTCs for their qualifying solar facility. Entities not subject to taxation such as cities, counties, municipal utilities, school districts and 501(c)(3) organizations (or tax-exempt entities) could not take direct advantage of these tax credits for the same type of solar facility. Now, under the IRA, these tax-exempt entities can receive the benefits of the tax credits through direct payments in lieu of tax credits. Solar facilities under construction prior to the end of 2022 may qualify for these direct payments if placed in service after 2022.

Under the direct payment option, the eligible tax-exempt entity will be treated as if it had paid taxes in the amount of the tax credit for which it can receive a cash refund. The direct payments apply to tax years beginning after December 31, 2022 and require the tax-exempt entity to make an election in order to receive the direct payment. An election for a direct payment is irrevocable and applies to any tax credit for the taxable year in which the election is made. Future guidance from the IRS will detail the process of how a tax-exempt entity (that is not required to file a return) can claim the credit, including the process for making the applicable election and the due date of the election.

In a statement from the IRS Assistant Secretary for Tax Policy in late March, 2023, it was stated that guidance will be coming in the "coming months" and in the following order: (1) clean vehicle credits (issued in late March), (2) bonus provisions for projects in historical energy communities, (3) bonus

provisions for projects utilizing domestically produced manufactured products, (4) direct pay and transferability, and (5) final prevailing wage and apprenticeship provisions. The same IRS statement it was noted that the IRS is in the process of developing an electronic pre-filing registration process for organizations that want to take advantage of direct pay.

Tax Credits

Tax-exempt entities can receive a direct payment of two types of tax credits for solar generation facilities. The first is the ITC which is a one-time credit based on a percentage of the basis of the solar facility. Tax-exempt entities with a solar facility generating electricity for its own use may be eligible for the ITC. The second credit is the PTC which is an annual credit based on the amount of energy produced and sold by a solar facility over a 10-year period. In order to qualify for the PTC, the energy produced from the solar facility must be sold unrelated third-parties. For purposes of this article, we will focus on the ITCs available for tax-exempt entities owning solar facilities and using the electricity generated for its own use.

Under the IRA a tax-exempt entity with a solar facility that will be placed in service after 2022 but before 2025 may qualify for the ITC in the amount of the base percentage of 6% of the basis of the solar facility However, a solar facility may receive an ITC in the amount of 30% of the basis if (1) the solar facility has a maximum net output of less than 1 megawatt of electrical (AC) energy, or (2) meets certain prevailing wage and apprenticeship requirements, or (3) the construction of the solar facility begins prior to the date which is 60 days after the publication of the IRS guidance on the prevailing wage and apprenticeship requirements (note that the preliminary IRS guidance which triggers the 60-day timeline was issued on November 30, 2022, which sets the in-construction deadline to qualify for this exemption at January 29, 2023). The IRA allows the cost of certain interconnection property installed in connection with a solar facility to be included in the basis of the facility for determining the amount of the ITC.

The IRA also provides that a standalone energy storage facility with a capacity of 5 kilowatt hours or more is eligible for the ITC in the amount of 30% if the prevailing wage and apprenticeship requirements are met or construction begins prior to January 29, 2023 (the date which is 60 days after the publication of the IRS guidance on prevailing wage and apprenticeship requirements).

The prevailing wage requirement is met if all laborers and mechanics employed by the owner of the solar facility or any contractor or subcontractor in the construction or repair of the solar facility are paid prevailing wages as determined by the U.S. Secretary of Labor for the location of the facility. Prevailing wages for the location of the solar facility must be paid during construction and for repairs and alterations occurring in the first five years of operation of the facility.

Failure to meet the prevailing wage requirement can result in significant penalties, including reduction of the ITC to the base amount of 6%, payment of a wage shortfall to the underpaid employee(s), and a $5,000 penalty per employee. For intentional disregard of the wage requirement, the penalty increases to three times the wage shortfall and $10,000 penalty per employee.

Additionally, the owner of the solar facility must ensure that, if the owner, contractor or subcontractor employs four or more employees, 10% of the labor hours spent on a solar facility that began construction in 2022 must be performed by qualified apprentices. The number of labor hours performed by qualified apprentices is 12.5% for solar facilities that begin construction in 2023, and 15% thereafter. A qualified apprentice is defined as an employee who participates in an apprenticeship program under the National Apprenticeship Act.

Similar penalties to the prevailing wage penalties apply for failure to satisfy the apprenticeship requirements; however, a “good faith” exception applies where an owner or employer attempts but cannot find qualified apprentices in the location of the solar facility.

Tax-Exempt Debt

If a solar facility has been financed with tax-exempt debt, the amount of the ITCs is reduced by the lesser of (1) 15% or (2) the portion of the facility that has been financed with tax-exempt debt. As drafted, this "lesser of" test this allows solar facilities to be completely financed with tax-exempt debt while only reducing the amount of the ITC by 15%.

Credit Enhancements

Solar facilities that qualify for the ITC may qualify for certain increases in the tax credit base amount. One of the increases is the U.S. domestic content bonus and is for solar facilities that use 100% U.S. steel and iron or a portion of the total costs of the manufactured components are made with products that are mined, produced or manufactured in the U.S. The portion of total costs of manufactured components is initially set at 40%, increasing to 45% in 2025, 50% in 2026 and 55% in 2027. Solar facilities satisfying this U.S. domestic content requirement can receive an additional 10% ITC bonus; however, solar facilities failing to meet the prevailing wage and apprenticeship requirement only receive an additional ITC bonus of 2%. The U.S. domestic content bonus is only available for solar facilities placed in service after December 31, 2022. Due to the current sourcing options for solar project facilities and ongoing supply chain issues, it is unclear how useful this bonus credit will be to most projects.

Another ITC bonus is the environmental justice bonus and is available for solar facilities with a maximum net output of 5 megawatt (AC) or less where the facility is located in, or services, a low-income community. A low-income community is one having a certain poverty rate or low median family income. A solar facility must receive an allocation from the IRS in order to access this bonus credit. The amount of allocation available for each calendar years 2023 and 2024 is limited to 1.8 gigawatts (AC). Solar facilities meeting the environmental justice requirements may receive an additional 10% ITC bonus. Storage facilities installed in connection with a solar facility also qualify for the environmental justice bonus, but stand-alone storage facilities do not. A solar facility receiving an allocation of environmental justice bonus credit must be placed in service within 4 years of the date it receives an allocation from the IRS. The process of allocating the environmental justice bonus amounts will be set forth by the IRS in upcoming guidance.

Conclusion

The enactment of the IRA provides tax-exempt entities with a real opportunity to take advantage of solar-related tax credits that were not directly accessible to such entities previously. These provisions should provide tax-exempt entities greater flexibility in structuring the ownership and financing plans for their solar facilities, perhaps leading to lower costs for such projects.

Tax credit law is complicated, and the determination of whether a particular solar project will qualify for the tax credits (and how much), will be a fact-based question unique to each project. Additionally, there are still requirements and guidance to be provided by the IRS with respect to these new opportunities, so some questions cannot be fully answered at this point. Consultation with counsel is recommended on this issue.

We will continue to provide additional information on this topic as guidance from the IRS is released, but tax-exempt entities should take steps now to prepare for qualifying for these significant benefits.