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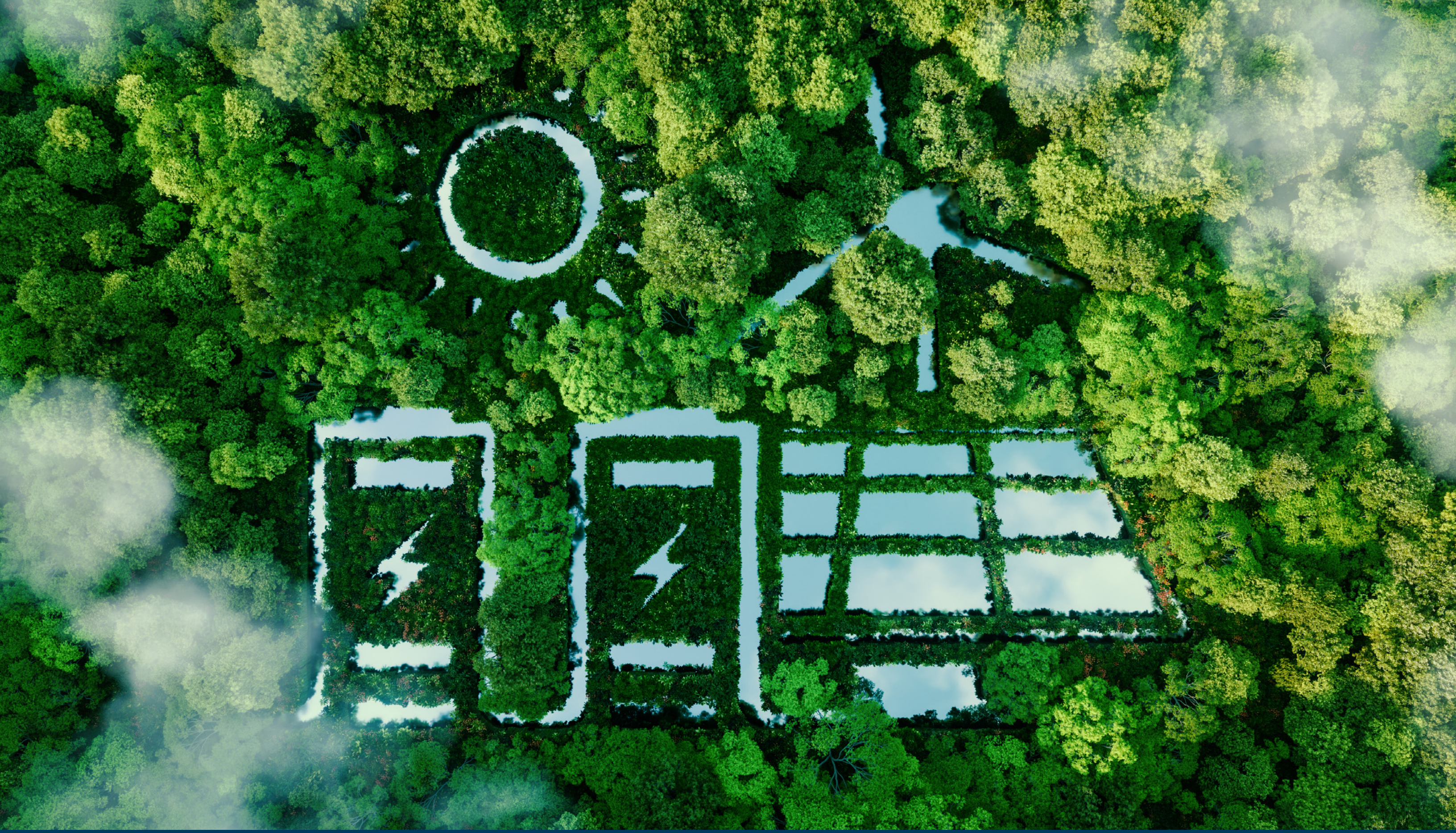

HOW THE INFLATION REDUCTION ACT AFFECTS TAX CREDITS FOR ELECTRICITY GENERATION AND STORAGE PROJECTS

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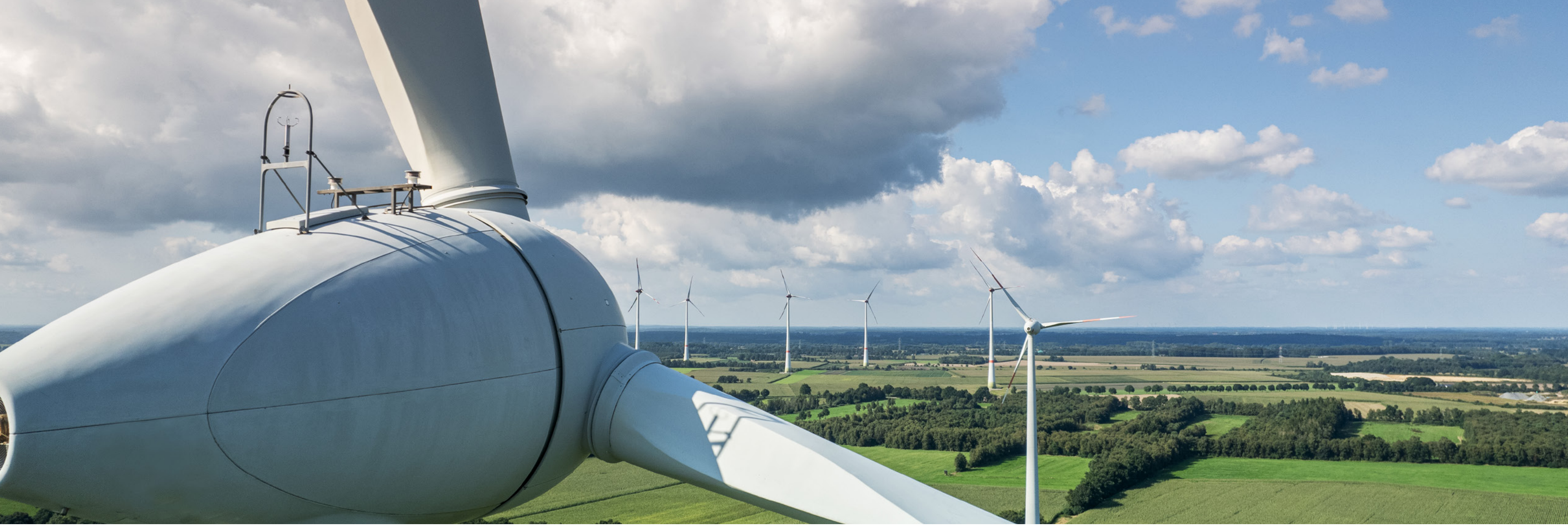
INTRODUCTION

On Aug. 16, 2022, President Joe Biden signed into law the Inflation Reduction Act of 2022 (IRA), which includes new and revised tax incentives for clean energy projects. The IRA extended, expanded and significantly modified the federal tax credits available for wind and solar generation and energy storage projects.

REVISED AND EXPANDED TAX CREDITS

The Section 45 Production Tax Credit (PTC) and Section 48 Investment Tax Credit (ITC) have played a significant role in promoting the growth of the wind and solar energy industries in the United States for several decades. These credits have provided financial support for the development of these renewable energy projects and helping to reduce the cost of these methods of energy generation over time. Both credits have undergone several changes since inception, with the credit amount and eligibility requirements varying over time. The IRA is a significant update to these credits, the extent to which is discussed in the sections below.

In this Issue



WIND GENERATION

The PTC provides a tax credit to eligible wind energy projects based on the amount of electricity produced by the project. The credit is calculated as a certain number of cents per kilowatt-hour of electricity produced, and the credit amount is set by Congress and can vary over time. Prior to the enactment of the IRA, the PTC had phased out for wind projects that began construction in 2022 or later. The PTC rate for wind projects was subject to the following phased reductions:

- Wind projects that began construction before the end of 2016 – 100%
- Wind projects that began construction in 2017 – 80%
- Wind projects that began construction in 2018 – 60%
- Wind projects that began construction in 2019 – 40%
- Wind projects that began construction in 2020 – 60%
- Wind projects that began construction in 2021 – 60%
- Wind projects that began construction after 2021 – PTC not available

The IRA has eliminated the Section 45 PTC phase-out for any wind project that is placed in service after Dec. 31, 2021,[1] and has extended the credit for an additional three years, from 2022 until the end of 2024. This extension has added requirements that projects must meet certain labor qualifications (the prevailing wage and apprenticeship requirements, discussed below) in order to be eligible for the full credit. This is done by establishing a PTC base rate of 0.3¢/kWh (adjusted annually for inflation)[2] and then providing a 5x multiplier for those projects that satisfy the new prevailing wage and apprenticeship requirements. The result is a restoration of the 100% PTC for projects that satisfy the new wage and labor rules and a 20% PTC for projects that do not satisfy these new wage and labor rules.

In addition to this extension of the existing credit, a production tax credit for wind projects was further extended through at least 2033 under the Section 45Y PTC (discussed below).

[1] The existing PTC phase-down of the credit to 60% of maximum value continues to apply for any wind project placed in service before Jan. 1, 2022.

[2] Per Announcement 2022-23, the inflation adjusted base rate is 0.55¢/kWh.

SOLAR GENERATION

The ITC provides a tax credit for deploying eligible solar generation projects. The credit is calculated as a percentage of the fair market value of solar energy property placed in service. Prior to the enactment of the IRA, the ITC had phased down from a 30% maximum credit in the year ending Dec. 31, 2019, and was subject to the following reduced values:

- Maximum credit of 26% for projects that began construction in 2020-2022
- Maximum credit of 22% for projects that began construction in 2023
- Maximum credit of 10% for projects that began construction in 2024 and thereafter

The IRA retains the ITC for solar generation projects and reestablishes an opportunity to claim a 30% tax credit. Under the revised statute, the full 30% rate is deemed a "bonus rate" that taxpayers are entitled to only if the project is under 1MW of generation output or if the new prevailing wage and apprenticeship requirements (discussed below) are met. Otherwise, a base ITC rate of 6% applies to solar generation.

The IRA also made solar generation eligible for the Section 45 PTC for the first time. Instead of a one-time 30% ITC given in the year a solar project is placed in service, taxpayers can elect to claim a solar PTC every year over a 10-year credit period.[3] The qualifications for solar generation facilities are the same under either credit, but the PTC represents an opportunity for large-scale solar projects to generate more value over time than in a single ITC claimed in the placed-in-service year.

The ITC (or the PTC, if elected) will apply to solar projects that begin construction before the end of 2024, after which solar generation will be eligible for the new Section 48E ITC (or Section 45Y PTC, if elected) through at least 2033.

[3] The present maximum PTC rate is 2.75¢/kWh for solar generation placed in service in 2022, but rates will fluctuate going forward.

ENERGY STORAGE

Before the enactment of the IRA, no tax credit applied to stand-alone energy storage projects. Energy storage installed as a component of a solar or wind generation facility was eligible for a credit when included among the equipment associated with that project and its tax credits.

The IRA adds Section 48(a)(3)(A)(ix) to create an ITC for stand-alone energy storage technology with a minimum capacity of 5 kWh. This includes batteries, but it also applies more broadly to any energy storage technology that receives, stores and delivers energy for conversion to electricity, or to most technology that thermally stores energy (excluding swimming pools, combined heat and power systems, and building structural components). Energy storage that is placed in service after Dec. 31, 2022, and that begins construction prior to Jan. 1, 2025, is entitled to the existing ITC. The same base-rate ITC concept that applies to solar generation also applies to energy storage projects. The 30% bonus rate is available if the project is under 1MW of storage capacity or if the new prevailing wage and apprenticeship requirements are met; otherwise, the energy storage project is entitled only to the 6% base rate. Additionally, energy storage installations that begin construction after Dec. 31, 2024, will be entitled to credits under the technology-neutral Section 48E.

On top of establishing a tax credit for energy storage, the IRA also added some clarity to the tax consequences for taxpayers deploying energy storage in a fee-for-service context. Project owners claiming the ITC when contracting with a tax-exempt off-taker must understand whether the contract with the off-taker will be considered a lease or a service contract by the IRS under Section 7701(e). This determination can shift a taxpayer's depreciation to straight line, require fair market value purchase options and even cause an outright denial of the taxpayer's ability to claim the ITC.

The IRA removes doubt for energy storage property, as defined in Section 48(a)(6), by explicitly stating that a service contract for operation of an energy storage facility will be respected and not recharacterized as a lease so long as four safe-harbor criteria are followed: The tax-exempt off-taker cannot have a right to operate the facility, cannot have a purchase option other than for fair market value and cannot benefit from operational cost savings, and the tax-exempt entity must have meaningful rights in the case of the project's nonperformance under the off-take contract. Being able to rely on the service contract safe harbor under Section 7701(e) avoids uncertainty about claiming the ITC for contracts to provide storage services to tax-exempt and governmental entities.

Additionally, the IRA provides energy storage property an election out of the Section 50(d)(2) "public utility property" normalization method of accounting limitation for facilities with a capacity exceeding 500 kWhs. The normalization method creates a drag on tax credit value as compared to nonregulated taxpayers because of how public utilities are required to structure their rates. This new section should help encourage deployment of larger energy storage projects by regulated utilities as part of their infrastructure spending.

CLEAN ELECTRICITY PRODUCTION AND INVESTMENT CREDIT

As briefly touched upon above, the IRA reaffirmed and extended the existing PTC and ITC until 2025. For years after that, the IRA has established a new PTC under Section 45Y and new ITC under Section 48E. Both credits are technology-neutral and grant a 30% credit opportunity to facilities that generate or store energy and that produce greenhouse gas emissions not greater than zero.

Like the existing PTC, the new Section 45Y clean electricity PTC is available for the 10-year period following the facility's placed-in-service date. The credit is subject to the base rate/bonus rate concept dependent upon meeting the prevailing wage and apprenticeship requirements. The Treasury Secretary will publish annual greenhouse gas emission rates for categories of technologies for taxpayers to use for purposes of determining their eligibility.

The Section 48E clean electricity ITC is available for any investment in a qualified facility or energy storage project that is placed in service after Dec. 31, 2024, if the project produces or stores electricity with a greenhouse gas emissions rate of not greater than zero. Taxpayers electing the ITC will receive a credit up to 30% of the investment in the year the facility is placed in service, subject to the base rate/bonus rate requirements for prevailing wage and apprenticeship.

The clean electricity PTC and ITC will begin a planned phase-out to reduce the credit value over a three-year period that begins in the first calendar year after the "applicable year," which is later of (i) 2032 or (ii) the calendar year in which the Secretary determines that the annual greenhouse gas emissions from electricity generation are 75% lower than 2022. Assuming 2032 is the "applicable year," the phase-out reduces the maximum PTC/ITC value rapidly; the full credit will last until 2033, then the value will drop to 75% of the maximum in 2034 and 50% of the maximum in 2035. Thereafter, the PTC/ITC will no longer be available unless extended.

NEW CONDITIONS AND OPPORTUNITIES

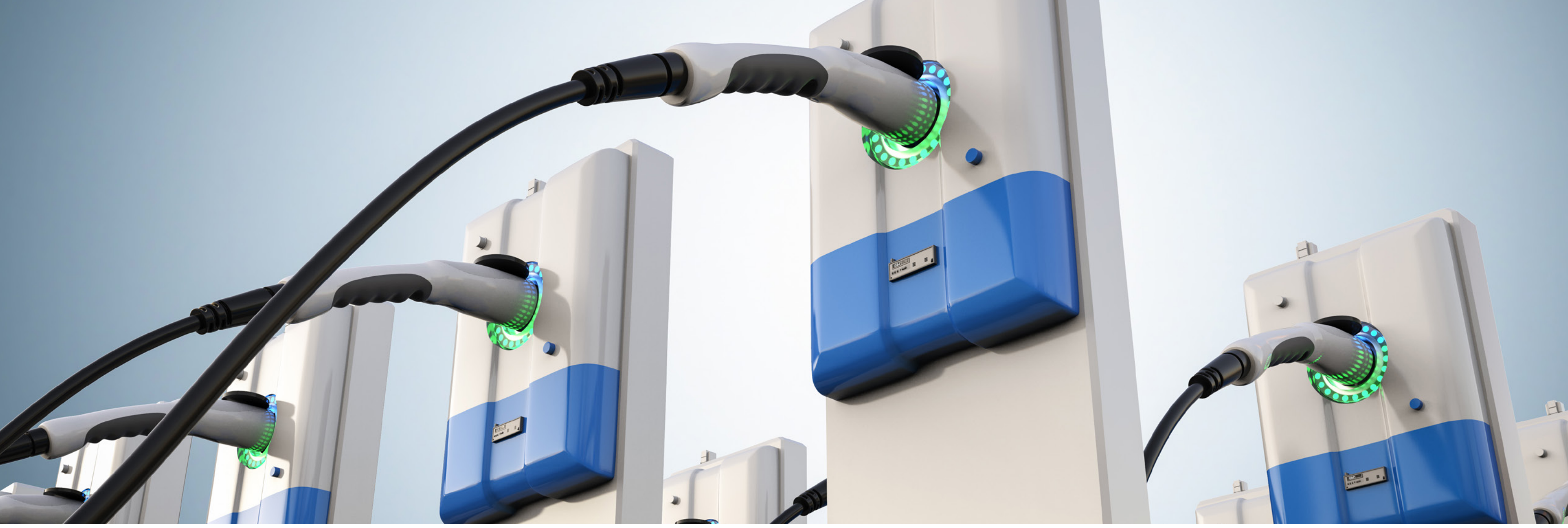
Direct Pay and Transferability

The IRA has opened new ways to use the PTC and ITC though direct payment and transfer provisions that did not exist in earlier versions of the law. These changes have the potential to significantly alter the tax considerations in energy transactions.

Section 6417 makes the PTC and ITC (including the Section 45Y and Section 48E credits) refundable direct-pay credits but only for tax-exempt entities, state and local governments, tribal governments, Alaska Native Corporations, the Tennessee Valley Authority and rural electric cooperatives. Projects that begin construction after 2023 and claim direct pay will need to satisfy domestic-content requirements if the projects are 1 MW or larger. If the domestic-content requirement is not satisfied, the amount of credit treated as a direct payment is subject to a graduated phase-out (90% of maximum if construction starts in 2024, 85% if construction starts in 2025 and 0% thereafter). An exception to the phase-out is available either if the inclusion of steel, iron or manufactured products that are produced in the United States increases the overall costs of construction by more than 25%, or if the necessary steel, iron or manufactured products are not produced in the United States in sufficient available quantities or are not of a satisfactory quality. Despite these administrative hurdles, the direct pay opportunity changes the landscape for tax-exempt entities to enter energy transactions.

Historically, nonprofit organizations that wanted to implement renewable energy projects faced financial challenges because they were unable to directly take advantage of energy tax benefits. To overcome this obstacle, these organizations often entered into power purchase agreements (PPAs) with developers or banks that could claim the tax credits. Under the terms of a PPA, the organization would pay the developer or bank for a specified period of time, typically 25 years, in exchange for the energy produced. However, with the introduction of direct pay, tax-exempt organizations such as public schools, cities and nonprofits can now receive a check for 30% of the project cost as a credit, similar to how tax-paying entities receive credits when filing their taxes. Section 6417 enables these organizations to own and operate their own solar projects rather than simply purchasing power through PPAs.

Section 6418 added a new transfer provision to permit project owners (other than tax-exempt entities) to make an election to transfer the PTC or the ITC (including the Section 45Y and



Section 48E credits) to a third party. The amount paid by the third party for the tax credit must be in cash, is not included in the gross income of the transferee and is not deductible to the transferor. An election to transfer the tax credits must be made on or before the due date for the tax return in the year the credits were determined, so credits that are carried forward cannot be later transferred. Once a credit is transferred, the credit cannot be further transferred by the transferee. The election to transfer credits to a third party applies to credits determined after 2022, regardless of when the project was placed in service. This means operating wind farms with remaining years of PTC eligibility could take advantage of the PTC transfer rules for operating years 2023 and later.

The Section 6418 transfer rules likely will have a significant impact on wind, solar and storage project financing, as sponsors might elect to simply monetize the PTC or ITC rather than bring in tax equity partners. The simplified transfer rules could avoid cumbersome governance and ongoing compliance matters that affect operating generation assets. However, the tax credit market may seek indemnities from sponsors and parent guaranties, related to the tax credits' original determination and qualification. This could have a separating effect in a tax credit market between creditworthy sponsors and the rest of the industry. Expect tax insurance to play a large role in the new tax credit transfer market.

Prevailing Wage and Apprenticeship Requirements

As mentioned, to qualify for the bonus rates under the PTC and ITC, an energy project will need to satisfy the prevailing wage and apprenticeship requirements. If these requirements are not met, the project will be eligible only for the base rate. Specifically, a taxpayer must (i) pay "laborers and mechanics" (distinct from managerial and administrative workers) a prevailing wage, and (ii) ensure the employment of an adequate number of apprentices from registered apprenticeship programs. In Notice 2022-61, the IRS provided the first guidance on how taxpayers may demonstrate they have achieved these objectives.

Prevailing wages must match the pay rates published by the Department of Labor (DOL) for geographic areas and for types of jobs or labor classifications. If relevant wage rates have not been published, the taxpayer must affirmatively contact the DOL for a wage determination, providing the type of facility being constructed, location, proposed labor classifications, proposed prevailing wage rates, job descriptions and duties, and any rationale for the proposed classifications.

Apprentice employment generally requires that no fewer than the "applicable percentage" of total labor hours are performed by qualified apprentices. The applicable percentage is (i) 10% for projects that begin construction in 2022, (ii) 12.5% for projects that begin construction in 2023, and (iii) 15% for projects that begin construction in 2024 or later. Apprentice labor hours are the dominant factor in establishing apprentice employment but, depending on the project or contractor characteristics, the adequacy of apprentice employment also can include specific headcount requirements.

Compliance with prevailing wage and apprenticeship is demonstrated through record keeping. Notice 2022-61 included examples of the types of records a taxpayer must keep, including the wage rates provided by the DOL, the laborers and mechanics who performed construction work on the project (and whether they are qualified apprentices), the classifications of work they performed, their hours worked in each classification and the wage rates paid for the work. The apprenticeship labor requirements have a good-faith exemption that applies if the taxpayer requests qualified apprentices from a registered apprenticeship program and the request is denied or goes without response for more than five business days — effectively keeping taxpayers from being penalized if there are insufficient apprentices to hire. Additionally, taxpayers are generally permitted to cure noncompliance with additional payments to the worker, plus interest, and/or penalty payments to the IRS.

Two exemptions exist from the prevailing wage and apprenticeship requirements:

1. Smaller-scale storage projects (under 1MW of storage capacity) qualify for the 30% bonus rate regardless of compliance with the prevailing wage and apprenticeship requirements.
2. Storage projects not in service prior to Jan. 1, 2022, and on which construction begins prior to Jan. 29, 2023 (60 days after the IRS issued Notice 2022-61), qualify for the bonus rate regardless of compliance with the prevailing wage and apprenticeship requirements.

The clarification of record-keeping requirements and taxpayer's affirmative duties to get wage determinations are important developments to arise from Notice 2022-61, but the most significant aspect of the notice is the start of the 60-day clock on the second exemption. The IRS has promised additional guidance and regulations on these requirements and exemptions, which may change the record-keeping and exemption landscape in 2023.

Domestic Content Bonus

Generation and storage projects placed in service after Dec. 31, 2022, that satisfy a new domestic-content requirement will be entitled to a 10% credit increase (2% for base credit) for PTC and a 10% points (2% for base credit) increase for ITC. Eligibility for the domestic-content bonus credit is based on whether any steel, iron or manufactured product that is a component of the facility was produced in the United States. For this purpose, a manufactured product will be deemed to have been produced in the United States if not less than the "adjusted percentage" of the total costs of all such manufactured products is attributable to manufactured products (including components) that are mined, produced or manufactured in the United States.

The adjusted percentage is generally (i) 40% for facilities that begin construction before 2025, (ii) 45% for facilities that begin construction in 2025, (iii) 50% for facilities that begin construction in 2026, and (iv) 55% for facilities that begin construction after 2026. For offshore wind facilities, the adjusted percentage is (i) 20% for facilities that begin construction before 2025, (ii) 27.5% for facilities that begin construction in 2025, (iii) 35% for facilities that begin construction in 2026, (iv) 45% for facilities that begin construction in 2027, and (v) 55% for facilities that begin construction after 2027.

Energy Community Bonus

Generation and storage projects placed in service after Dec. 31, 2022, and located within an "energy community" also will be entitled to the 10% credit increase (2% for base credit). An energy community is defined to include (i) a brownfield site; (ii) a census tract or any adjoining tract in which a coal mine closed after Dec. 31, 1999, or a coal-fired electric power plant was retired after Dec. 31, 2009; and (iii) an area that has (or, at any time during the period beginning after Dec. 31, 1999, had) significant employment or local tax revenue related to the extraction, processing, transport or storage of coal, oil or natural gas.

Low-Income Bonus

Certain qualified solar and wind facilities with a maximum output of less than 5 MW may be eligible for an additional ITC. Projects can receive an additional 10% credit if located in a low-income community or on Indian land, or an additional 20% credit if such project is part of a qualified low-income residential building project or qualified low-income economic benefit project. To receive these credit enhancements, projects must apply for an allocation of an annual 1.8 GW environmental justice solar and wind capacity limitation under a program that Congress directed Treasury to create no later than 180 days of enactment, which translates to Feb. 12, 2023. Stand-alone energy storage is not eligible for this credit, but energy storage installed in connection with wind and solar projects may be eligible.

McGuireWoods is a leading law firm in the renewable energy industry. We have been involved in projects in more than 40 states totaling over 27 GWs, and represent utilities, developers, independent power producers, and infrastructure funds – some of whom are looking for partners, investors and off-takers for their projects. Our strong, full-service practice provides assistance in all aspects of the development, acquisition/disposition, construction, offtake, debt finance, tax equity finance, ownership and operation of renewable energy projects. In addition, our experience spans the resource spectrum utilized today, including solar, biomass (including wood, wood waste, LFG, animal and plant waste), wind (on- and off-shore), energy storage, and geothermal projects. To learn more, please visit www.mcguirewoods.com.

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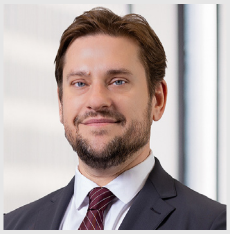

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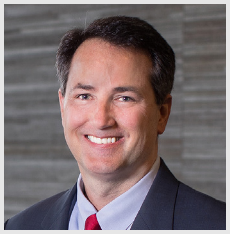

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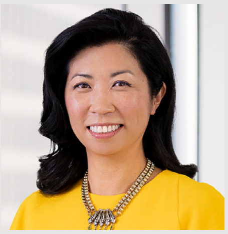

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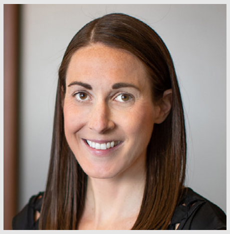

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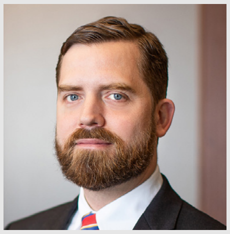

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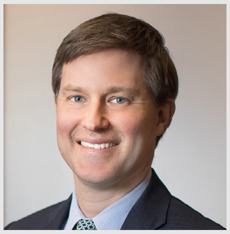

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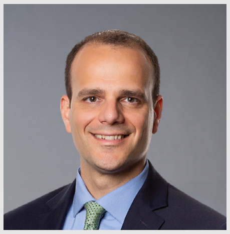

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