

Unlocking Clean Energy Investments: New Elective Payment Credits for State and Local Governments

Legal Alert
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State and local governments undertaking clean energy projects may be eligible for cash payments equal to the renewable electricity production tax credit or energy investment tax credit that would have been available to a private entity. The new “elective payment credits” are available for certain qualified projects (e.g., certain wind, biomass, geothermal, solar, landfill and trash, hydropower, marine, hydrokinetic, fuel cell, solar, and biogas facilities) that have satisfied pre-registration and application requirements and will be placed in service after December 31, 2024.

Background

The Inflation Reduction Act of 2022, P.L. 117-169 (August 16, 2022) (the “IRA”) provides new incentives for more investment in clean energy property, including investments by state and local governments. In particular, the IRA added Section 6417 of the Internal Revenue Code of 1986, as amended (the “Code”) to allow state and local governments to obtain elective cash payments of applicable credits with respect to applicable credit property. Before enactment of the IRA, only private entities required to pay federal income tax could take advantage of these federal tax credits.

Under the new provisions and related proposed regulations, a state or local government (an “applicable entity”) that invests in applicable credit property is treated as having made a federal tax payment equal to the amount of the federal tax credits associated with the credit property. The state or local government can file a claim for a cash refund from the United States of the deemed federal tax payment, thereby “monetizing” the federal tax credits. These federal payments are referred to as “elective payment credits.”

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The amount of an elective payment credit is governed by the terms of existing provisions of the Code that provide federal tax credits with respect to investments in various types of clean energy property for for-profit entities (“credit property”). The credits are available to state and local governments for facilities placed in service after December 31, 2024. The types of available credits are:

- **Renewable electricity production tax credit (“PTC”).** Section 45 of the Code allows a credit based on a specified number of cents per kilowatt hour produced in a taxable year from qualified energy resources at a qualified facility during a 10-year credit period beginning on the date the facility was originally placed in service. “Qualified facilities” (and the related “qualified energy resources) include (among others) certain wind, biomass, geothermal, solar, landfill and trash, hydropower, and marine and hydrokinetic facilities construction of which begins before January 1, 2025.
- **Energy investment tax credit (“ITC”).** Section 48 of the Code permits a one-time payment based on a specified percentage of the cost (qualified basis) of certain types of energy property, including (among others) fuel cell, solar, geothermal, small wind, and biogas property construction of which begins before January 1, 2025. The base credit percentage is 6 percent, but the percentage increases to 30 percent if prevailing wage and apprenticeship program requirements are met in the construction of the property. The ITC can be claimed in the year that the credit property is first placed in service.
- **“Technology-neutral” PTC and ITC.** Section 45Y and Section 48E continue to provide a PTC or ITC, respectively, with respect to any “qualified facility,” e., any facility (i) used to generate electricity, (ii) placed in service after December 31, 2024, and (iii) for which the anticipated greenhouse gas emissions rate is not greater than zero. The amounts of these credits for these types of credit property are briefly summarized in the IRS publication “Clean Energy Tax Incentives: Elective Pay Eligible Tax Credits.”

An applicable entity may claim either the PTC or the ITC, but not both, with respect to the same credit property. The PTC and the ITC also are subject to reduction if the credit property is financed with proceeds of tax-exempt bonds, as described below.

Application to Receive Elective Payment Credits

Pre-Filing and Registration Process. To obtain the credits, a state or local government is required to satisfy certain pre-filing registration requirements and obtain a registration number through an electronic filing portal at the IRS for each applicable credit property as a condition of, and prior to, making any elective payment election to receive elective payment credits. To register, the government is required to provide detailed information about itself and the credit property with respect to which the government intends to make an elective payment election. If the government intends to make an elective payment election for ITC, the government must

identify the source of funds to be used to acquire the credit property. If proceeds of tax-exempt bonds are going to be used to pay all or part of the cost of the credit property, the elective payment credits will be reduced. The Pre-Filing Registration Tool which is available on the IRS website as publication 5884 was released in December 2023. The User Guide for the registration tool indicates that elective payment credits under Section 45Y and Section 48E of the Code for facilities placed in service after December 31, 2024, remain “pending.”

Forms for Making an Elective Payment Election. The Proposed Regulations provide that an elective payment election would be made by a state or local government by filing IRS Form 990-T – Exempt Organization Business Income Tax Return (a form normally filed by nonprofit 501(c) organizations to report taxable unrelated trade or business income) and Form 3800 – General Business Credit (a form normally filed by nongovernmental entities to claim various types of federal tax credits). Form 3800 also requires the filing of other forms related to the particular federal tax credit that is claimed, such as Form 8835 – Renewable Electricity Production Credit or Form 3468 – Investment Credit for clean energy property. The IRS published a revised Form 990-T in January 2024 to accommodate filing by applicable entities, including state and local governments, to claim elective payment credit amounts from Form 3800.

Sequestration of Elective Payment Credits. Federal credit payments to issuers of build America bonds (“BABs”) have been subject to “sequestration” under the federal Balanced Budget and Emergency Deficit Control Act of 1985 (the “Budget Control Act”) and the Taxpayer Relief Act of 2012. The federal courts have ruled that those federal credit payments constitute a type of federal “direct spending” that is subject to “sequestration,” *i.e.*, mandatory cancellation and reduction in certain percentage amounts as determined by the federal Office of Management and Budget. These reductions have been implemented by the U.S. Treasury’s making reduced federal credit payments to the issuers of BABs. Under the Budget Control Act, federal payments to *individual taxpayers* pursuant to provisions of the Code establishing refundable income tax credits are exempt from sequestration, but federal credit payments to state and local governments are not exempt. As a result, elective payment credits to state or local governments with respect to clean energy property under Section 6417 of the Code also are likely to be subject to sequestration.

Federal Tax Considerations When Credit Property is Financed With Tax-Exempt Bonds

Reduction of Elective Payment Credits. If a state or local government uses proceeds of tax-exempt bonds to acquire the credit property, the elective payment credits with respect to the credit property will be reduced by a percentage, but not by more than 15 percent, based upon the percentage of the cost of the credit property that was financed with proceeds of the tax-exempt bonds. Thus, for example, if 100 percent of the cost of the credit property was financed with tax-exempt bonds, the elective payment credits would be reduced by 15 percent, and if 10 percent of the cost of the credit property was financed with tax-exempt bonds the elective

payment credits would be reduced by 10 percent.

Applying this rule becomes more complicated if both bond proceeds and other amounts (such as “qualified equity” as defined under the private activity bond regulations for tax-exempt bonds) are used to finance multiple projects, including some credit property. It is not clear under Section 6417 or the Proposed Regulations whether the use of tax-exempt bond rules for allocating bond proceeds and other amounts to finance multiple projects, including some credit property, also would be permissible under the rules for reducing elective payment credits under Sections 45/45Y and 48/48E of the Code.

Treatment of Elective Payment Credits for Tax-Exempt Bond Purposes. There may also be a question as to whether the elective payment credits should be treated as “replacement proceeds” of the tax-exempt bonds, depending on how the state or local government uses the credit proceeds. For example, if periodic elective payment credits received by the bond issuer during the 10-year credit period based upon claiming the PTC for the credit property are specifically pledged and deposited in a debt service or sinking fund for payment of debt service on the bonds, those receipts would be treated as “replacement proceeds” of the bonds. For general obligation bonds to which the issuer has pledged its full faith, credit and resources, if the issuer does not create any specific legal nexus between receipts of elective payment credits and debt service on the bonds, the elective payment credits should be treated solely as payments made by the United States to encourage the development of clean energy property that are part of the issuer’s general revenues not having any direct nexus to the tax-exempt bonds issued to finance the applicable credit property.

Similarly, there might be a question whether the receipt by a state or local government of the one-time elective payment credit for the ITC should be treated as “replacement proceeds” of any tax-exempt bonds issued to finance the credit property. Treas. Reg. §1.148-1(c)(1) provides that “Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose.” The IRS might assert that the elective payment credit based on the ITC should be treated as “replacement proceeds” of the tax-exempt bonds because the issuer would have used the elective payment credit to finance the credit property if bond proceeds were not used for that purpose. The better view is that the issuer is first required to finance the cost of the credit property (whether from bond proceeds or otherwise) and then place the credit property in service *prior* to making any claim for the elective payment credit with respect to the financed credit property. The elective payment credit would not have been available to the issuer to pay costs of the credit property.

The National Association of Bond Lawyers (“NABL”) has requested additional guidance from the IRS on these issues.

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Avoidance of Elective Payment Credits Being Treated as a “Federal Guarantee” of Tax-Exempt Bonds. A state or local bond cannot be tax-exempt if it is federally guaranteed, with certain exceptions. Elective payment credits by the United States under Section 6417 of the Code payable to a state or local governments that may issue tax-exempt bonds to finance applicable credit property should not be treated as having a direct nexus with the payment of debt service on those bonds. However, Section 6417 of the Code does *not* contain any express disclaimer of any federal guarantee like the disclaimer that was enacted by Congress with respect to build America bonds, and it might be asserted that the issuer’s receipt of elective payment credits in connection with credit property financed with tax-exempt bonds results in a guarantee, in whole or in part, of those bonds, which would result in the loss of their tax exemption. The Proposed Regulations under Section 6417 do not contain such a disclaimer of a federal guarantee.

NABL also has requested additional guidance from the IRS confirming that an issuer’s receipt of elective payment credits will not be treated as resulting in a federal guarantee of tax-exempt bonds issued to finance applicable credit property.