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Client Alert Commentary

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Key Senators Agree to Significantly Expand Tax Incentives for Clean Energy

The Inflation Reduction Act, which includes the most dramatic expansion of clean energy tax credits in recent history, would provide a multi-year extension of existing tax credits for wind and solar, increase tax credits for carbon capture, and add new tax credits for many emerging technologies.

Key Points:

- Wind and solar tax credits would receive a multi-year extension at full rates.
- New tax credits would be available for emerging technologies, including energy storage and clean hydrogen.
- Carbon capture tax credit rules would be simplified and expanded.
- Certain tax credits may be converted to cash payments from the Treasury under a new direct pay program or sold in the market under new tax credit transfer procedures.
- Tax incentives would be available to support and grow the clean energy supply chain in the US.

In a surprising development after months of stops and starts, key members of the US Senate have agreed to a new reconciliation bill that would expand and extend clean energy tax credits, significantly accelerate the clean energy transition, and create new avenues for developing, financing and owning clean energy assets.

The Inflation Reduction Act (the Bill) would provide more than $350 billion in clean energy incentives and would enact long-term tax credit incentives for an expansive array of clean energy technologies. The tax credits in the Bill are very similar to those proposed in the Build Back Better Act that stalled in Congress last year. The Bill also includes a number of revenue raising provisions, most notably a new 15% corporate minimum tax (which will be the subject of future Client Alerts) and changes to the carried interest rules. The Bill is set to move quickly through Congress, where it may face resistance to some of its revenue raising provisions and for its failure to address the cap on the itemized deduction for state and local taxes.

New Tax Credit Architecture

The Bill introduces a new multi-tier tax credit structure for most tax credits, generally consisting of a lowered base credit equal to 20% of the current credit amounts, a “bonus” credit for full credit eligibility if a

project meets the applicable union labor standards, and in some cases, increased credits if the project contains domestic content or is located in certain energy communities.

To qualify for full tax credits, developers would generally be required to meet certain union labor standards, including by paying market wages to employees and employing apprentices, when possible. These requirements would kick in for projects that begin construction 60 days or more after the Treasury Department issues guidance on the applicable union labor standards.

The Bill would offer bonus tax credits to projects that satisfy certain domestic content requirements or that are located in certain energy communities, such as a brownfield site or areas that have had significant employment relating to fossil fuels. The additional credits would generally entitle project owners to a 10% increase in production tax credit (PTC) amounts or a 10 percentage point increase in the investment tax credit (ITC). The bonus credits would generally apply to projects placed in service after December 31, 2022.

Extended Green Energy Tax Credits

Restoration and Extension of Production Tax Credit

The Bill would restore the PTC to its full, unreduced amount for wind projects (both onshore and offshore), open and closed-loop biomass, hydropower, and certain other clean energy projects that begin construction at any time prior to 2025. Solar projects that begin construction prior to 2025 would be eligible to choose the PTC instead of the ITC.

As previously described, the Bill would make full PTC qualification subject to compliance with the union labor standards, and would offer increased credits for projects that use domestic materials or content and those projects located in certain low-income or energy communities.

Restoration and Extension of Investment Tax Credit

The Bill would extend the energy ITC at the full 30% rate for solar projects that begin construction at any time prior to 2025. The extended 30% ITC would also apply to a number of new technologies, such as energy storage, biogas property, and microgrid controllers. As with the PTC, the Bill would make full ITC qualification subject to compliance with the union labor standards, and would offer increased credits for projects that use domestic materials or content and those projects located in certain low-income or energy communities.

Expanded and Extended Carbon Capture Tax Credit

The Bill would extend eligibility for the carbon capture tax credit under Section 45Q for an additional seven years to 2033. The Bill would substantially lower the minimum capture thresholds required for carbon capture projects, removing a significant hurdle for many potential projects to qualify for tax credits. Electricity generating facilities only qualify for carbon capture credits if the carbon capture equipment is designed to capture at least 75% of the facility's carbon oxide output. As with the PTC and ITC, a carbon capture project is entitled to the full Section 45Q credit only if the union labor requirements are met. In general, the provisions of the Bill relating to Section 45Q would apply for projects or equipment placed in service after December 31, 2022.

New Green Energy Tax Credits

New Energy Storage ITC

The Bill would provide a 30% ITC to many stand-alone energy storage projects that begin construction before 2025. Under current law, energy storage projects qualify for tax credits only if they are charged from a tax-credit qualifying generation source, such as a wind or solar project. The Bill's definition of energy storage facilities is broad enough to encompass most of the conventional technologies used to store power, such as batteries, compressed air, and pumped storage. The ITC for stand-alone storage is subject to the same union labor standards and may qualify for the same increased credits relating to domestic contents and energy communities as other ITC-eligible projects. The ITC for standalone storage would generally apply for storage projects placed in service after 2022.

New Clean Hydrogen PTC and ITC

The Bill would create a new production tax credit for clean hydrogen projects and an investment tax credit in lieu of the production tax credit for those same facilities. "Clean hydrogen" is hydrogen produced through a process that results in lifecycle greenhouse gas emissions of at most 4 kilograms of CO_2 equivalents per kilogram of hydrogen. The credits are generally available after 2022 for facilities that begin construction before 2033. The production credit is determined based on the amount of clean hydrogen produced during the 10-year period following the date the production facility was placed in service, and both the production tax credit and ITC rates vary based on the facility's emissions rate per kilogram of hydrogen. Clean hydrogen credits cannot be claimed with respect to a facility that includes equipment that is being or has been used to generate carbon capture credits under Section 45Q. Importantly, clean hydrogen projects that source power from renewable energy generation sources may claim production tax credits on the renewable power projects even if the power is directly used by the same owner to produce clean hydrogen. The production tax credit for hydrogen would generally be available for hydrogen produced after 2022, and the investment tax credit would generally be available for facilities placed in service after 2022.

New Advanced Manufacturing Credit

The Bill would create a new advanced manufacturing production credit, intended to spur US manufacturing of certain clean energy components necessary for the production of solar, wind and storage facilities, as well as for certain critical minerals important to the manufacture of those renewable energy components. The amount of the credit would vary significantly depending on the component or material being produced; for example, certain components would be eligible for credit based on the component's weight or capacity, while certain others would have their credit based on the manufacturer's cost of production. The credit, which would be available for components produced and sold after 2022, would be reduced beginning in 2030 and eliminated for components sold after 2032.

New Nuclear Power PTC

The Bill would create a new nuclear PTC for electricity produced from nuclear power facilities and sold to unrelated parties. The nuclear PTC would be 0.3 cents per kilowatt of power sold to unrelated persons, minus 80% of the facility's gross receipts in excess of 2.5 cents per kilowatt. This credit would be multiplied by five if union labor standards similar to those for the PTC and ITC are met. This formula would operate to phase down the nuclear PTC for any year in which the price of power exceeds a certain threshold. The nuclear PTC would be available beginning in 2024 to facilities that are already in service at the time the Bill is enacted and would end after 2032.

Transition to Clean Electricity Tax Credits

The Bill would create a new clean electricity production tax credit and a new clean electricity investment tax credit for all power generation facilities that are placed in service after 2024, regardless of the technology used, if they generate no (or negative) CO_2 equivalents. These credits would be equivalent to rates for the PTC under Section 45 and the ITC under Section 48, discussed above, and would be subject to certain union labor standards. The credits would also be subject to a four-year step down and phase out, scheduled to begin in 2032 at the latest. The phase-out may begin earlier if the overall level of greenhouse gas emissions from the production of electricity in the US falls to 25% or less of the emissions rate in calendar year 2022.

Eligibility for the clean electricity credits would be determined by reference to an emissions table, to be published by the Treasury Department, listing categories of power production facilities and the CO_2 equivalent emissions of each (including lifecycle emissions for fuel combustion and gasification facilities). It appears that individual facilities can reduce the value shown in the emissions table to account for anticipated emissions capture by that facility (unless such capture is used to generate carbon capture credits). For facilities that do not fit within a category in the emissions table, the taxpayer may petition the Treasury Department for an individual determination of the facility's emissions.

Direct Payment and Credit Transfer Elections

The Bill proposes two alternative ways for project owners to monetize tax credits outside of conventional tax equity financings.

The first option is a more-limited version of the "direct pay" option that was originally proposed last year as part of the Build Back Better Act. Direct pay allows project owners to apply for tax refunds in an amount equal to the value of their tax credits, although many of the procedural and timing rules remain subject to future regulations. As proposed, the direct pay option is not available to wind, solar, storage or many other traditional renewable energy projects, unless those projects are owned by municipal co-ops, state or local governments or certain other owners that are exempt from federal income tax.

The direct pay option is more widely available to owners of projects claiming 45Q credits, clean hydrogen PTCs or ITCs and clean energy manufacturers, but generally only for the first five years of the tax credit period, after which the tax credits are no longer eligible for the direct pay election.

The second option permits project owners to freely sell their tax credits to unrelated taxpayers that are better able to make use of them. The transfer election applies broadly to almost all clean energy tax credits, but is generally not available to tax-exempt owners that are eligible to make a direct pay election. The buyer of any tax credits must pay cash for the credits—the seller does not include the purchase price in its income, and the buyer is not permitted to take a tax deduction for the purchase price. Tax credits can only be transferred once, and the buyer cannot make a credit transfer election to sell the same credit to another taxpayer. Tax credits can be sold on an annual basis and project owners can generally sell the credits from one part of their project (such as one wind turbine) and keep the tax credits on another part. The IRS is directed to write rules for tax credit transfers that may include registration requirements or other procedures to prevent fraud or abuse. Subject to certain timing restrictions, this "credit transfer" election is available for credits earned in tax years that begin after 2022.

Although certainly a welcome development, it is not clear whether the proposed direct pay and tax credit transfer elections will be adequate to break the tax equity logjam that is slowing the pace of clean energy deployment in the US. The direct pay election is limited in scope and provides little relief to anyone other than carbon capture, clean hydrogen, and clean energy manufacturing. The credit transfer election, while

broader in scope, has a number of drawbacks when compared to traditional tax equity. For one, the transfer election is available only for tax credits and not for other project tax benefits, such as accelerated depreciation. Additionally, tax credit buyers using the transfer election are not permitted to deduct the payments paid for tax credits (in contrast to tax equity investors, who are permitted a tax write-off of at least 50% on their tax equity investment), which may decrease the value of tax credits that are transferred rather than tax equity financed.

Despite these shortcomings, both the direct pay and credit transfer elections represent meaningful progress towards a system that provides clean energy investors with more flexibility and optionality for realizing maximum value from their tax credit subsidies.

Key Takeaways

The extension of existing green energy tax credits and the addition of a host of new tax credits for emerging clean energy technologies and manufacturing capacity should create a welcome boost to the clean energy sector. Additionally, adding new monetization options for those credits should create much-needed flexibility for developers to realize the full value of these subsidies through traditional tax equity or alternative tax credit transfer procedures.

Latham & Watkins will continue to monitor and report on developments related to the Bill.

Register for Latham's upcoming webcast, New Energies: Demystifying CCUS, as Latham lawyers discuss clean energy tax incentives and related topics.

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