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Practice Update

IRS Releases Proposed Rules for 2023 Applicants Seeking Low-Income Community Bonus Tax Credits

June 6, 2023

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On May 31, 2023, the IRS released a Notice of Proposed Rulemaking (Proposed Rules)[1] concerning the low-income communities bonus tax credit program established by the Department of Treasury in accordance with the Inflation Reduction Act of 2022 (IRA). The program administers the allocation of new environmental justice solar and wind capacity limitations for 2023 and 2024 among eligible applicants, thereby determining which owners of qualifying solar and wind facilities located in low-income communities will be able to claim up to a 20 percent bonus tax credit under Section 48(e).[2] Treasury established the program on February 16, 2023, with the publication of Notice 2023-17, which also included limited initial guidance regarding the process for allocating the 2023 annual capacity limitation.[3] The Proposed Rules change the phased-in application review process described in the Notice to a single initial review period for all applications and add specific facility ownership and location criteria for prioritizing allocations based on factors considered by Treasury to further program goals.[4] In addition, the Proposed Rules supplement the initial guidance by providing much needed expanded and more detailed information related to application procedures and compliance matters, clarifications of the meanings of terms such as "located in" with respect to geographical

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requirements and "in connection with" for purposes of determining whether energy storage technology (EST) is eligible property, the scope of what is required to satisfy the different "financial benefit" rules applicable to Category 3 facilities (Section 45(e)(2)(B)) and Category 4 facilities (Section 45(e)(2)(C)) in various scenarios, and the methodology for establishing satisfaction of the applicable standards and more.

Section 45(e)(2) was added by the IRA and permits an owner of a qualifying wind and solar facility which receives an allocation under the program to claim a 10 or 20 percent low-income bonus credit. A "qualified solar and wind facility" is defined as a facility that (i) generates electricity solely from a wind facility, solar energy property, or small wind energy property, (ii) has a maximum net output less than 5 MW AC and (iii) is either (A) located in a low-income community or on Indian land, or (B) part of a qualified low-income residential building project or economic benefit project. The owner of the qualifying facility must submit an application to the program pursuant to requirements determined at the discretion of the Secretary of Treasury for the facility to receive a capacity limitation allocation. Qualifying facilities located in a low-income community or on Indian land are eligible for a 10 percent bonus credit and those that are part of a qualified low-income residential building project or economic benefit project are eligible for a 20 percent bonus credit.

The Proposed Rules are proposed to apply to taxable years ending on or after the date that final rules adopting these rules are published in the *Federal Register*.

Additional Guidance and Clarifications

As noted, the Proposed Rules provide additional detailed guidance and clarifications on several topics.

Single Facility Rule

The rules add that a qualifying wind and solar facility is a single facility and, to prevent abuse of the less than 5 MW capacity requirement, include that multiple solar or wind energy properties or facilities that are operated as a single project are treated as a single facility for purposes of this rule. Multiple properties or facilities are treated as a single facility based on the relevant facts and circumstances using the factors set forth in Notice 2013-29, section 4.04(2), for wind facilities, and Notice 2018-59, section 7.01(2)(a), for solar facilities.

Inclusion of Energy Storage Technology (EST)

The Proposed Rules clarify how to determine when EST is considered "installed in connection with" eligible property and, therefore, included in basis for purposes of the tax credit adder. To be so considered, (i) the EST and the other eligible property must be owned by a single legal entity, located on the same or contiguous pieces of land, have a common interconnection point, and be described in one or more common environmental or other regulatory permits; and (ii) the EST must be charged at least 50 percent by the other eligible property. The charging requirement is deemed satisfied if the power rating of the EST is less than two times the capacity rating of the connected wind facility (in kW AC) or solar facility (in kW DC).

Meaning of "Financial Benefits"

The term "financial benefits" is used in Section 48(e)(2)(B) with respect to certain requirements applicable to Category 3 facilities (Qualified Low-Income Residential Building Projects) and in Section 48(e)(2)(C) with respect to different requirements applicable to Category 4 facilities (Qualified Low-Income Economic Benefit Projects). The Proposed Rules clarify the meaning of the term for each category, define the scope of such requirements under the program, and explain how satisfaction of

such requirements is determined in various factual situations.

Category 3 – Section 48(e)(2)(B)(ii) requires the "financial benefits" of the electricity produced by such facilities to be allocated equitably among the occupants of the dwelling units of the qualified residential property.

- This requirement is considered satisfied if at least 50 percent of the "financial value" of the net energy savings derived from the energy produced by the facility is distributed to the low-income dwelling units either on an equal basis per unit or proportionally based on energy usage.
- If the owner of the facility also owns the building, such financial value is calculated as the greater of (i) 25 percent of the gross value of the annual energy produced by the facility or (ii) the difference between the gross value of the annual energy produced and the cost to operate the facility.
- If the owner of the facility does not own the building, such financial value is calculated as the greater of (i) 50 percent of the value of the annual energy produced by the facility that the owner of the building receives through utility bill credits and/or cash payments for net excess generation or (ii) the value of the annual energy produced by the facility that the owner of the building receives through utility bill credits and/or cash payments for net excess generation minus any payments made by the building owner to the facility owner under a contractual arrangement associated with the energy produced by the facility.
- Special considerations apply (and are described in the rules) in the case of buildings that have master metering and sub-metering.

Category 4 – Section 48(e)(2)(C) requires at least 50 percent of the financial benefits of the electricity produced by such facilities to be provided to households with income less than 200 percent

below the poverty line for the applicable family size or less than 80 percent of area median gross income.

- This requirement is considered satisfied if (i) the facility serves multiple households; (ii) at least 50 percent of the facility's total output is distributed to qualifying low-income households; and (iii) the applicant provides such low-income households at least a 20 percent bill credit discount rate.
- Applicants are responsible for income verification and are required, at the time the facility is placed in service, to submit documentation that identifies each qualifying low-income household, the output allocated to such household in kW, and the method of income verification utilized.

It is worth noting that the commentary to the Proposed Rules indicates Treasury and the IRS considered but rejected lower bill credit discount rates of 10 or 15 percent to ensure low-income customers receive meaningful economic benefits. Thus, it is possible Treasury and the IRS might consider a downward adjustment in response to comments. On the other hand, the commentary also signals that providing financial benefits to low-income customers is a key program goal and may foreshadow the outcome of future decisions, to the extent furthering this goal is a relevant consideration.

Meaning of "Located" In

A facility is considered "located" in a low-income community (Category 1) or on Indian land (Category 2) if 50 percent or more of the facility's nameplate capacity is in the qualifying area. A facility's nameplate capacity percentage is determined by dividing the nameplate capacity of the facility's energy-generating units located in the qualifying area by the total nameplate capacity of all the energy-generating units of the facility. Nameplate capacity is measured in DC for solar facilities and AC for wind facilities.

Disqualifying Events

A facility will be disqualified from receiving an allocation previously awarded if prior to or upon the facility being placed in service:

- The location of the facility changes.
- The facility's nameplate capacity increases to 5 MW AC or more.
- The facility's nameplate capacity decreases by the greater of 2 kW or 25 percent of the awarded capacity limitation.
- The facility cannot satisfy the applicable financial benefits requirements (described above) for a Category 3 facility or Category 4 facility, in each case, as planned.
- The eligible property is not placed in service within four years after the date the applicant is notified of the allocation.
- An ownership change causes the facility to cease to satisfy the Ownership Selection Criteria (defined below) and the original allocation was awarded, in part, based on satisfaction of such selection criteria; unless the original applicant retains an ownership interest in the owner of the facility and the successor owner attests that the original applicant will either become the owner of the facility or have the right of first refusal after the expiration of the five year recapture period.

The rationale for treating a decrease in nameplate capacity as a disqualifying event is unclear given that the facility could have initially received the allocation based on the lower nameplate capacity and it is not readily apparent what harm is caused that could not be satisfactorily addressed by disallowing a proportionate amount of the allocation. Further, it is interesting to note that an equivalent increase in nameplate capacity does not result in a disallowance of the original allocation so long as the nameplate capacity remains less than 5 MW AC.

Applications and Allocation Approach

The capacity limitation for 2023 is 1.8 GW DC and remains as described in the Notice – that is, 700 MW to Category 1 (Low-Income Community);[5] 200 MW to Category 2 (Indian Land);[6] 200 MW to Category 3 (Qualified Low-Income Residential Building Project);[7] and 700 MW to Category 4 (Qualified Low-Income Economic Benefit Project).[8] However, the Proposed Rules subdivide the 700 MW allocated to Category 1, such that 560 MW is allocated to residential behind the meter (BTM) facilities, and 140 MW is allocated to non-residential BTM and front of the meter (FTM) facilities.

As noted above, the Proposed Rules change the approach for awarding allocations and provide more detailed information on, inter alia, the application and related compliance requirements. Applications must be submitted by the owner of the qualified facility before the facility is placed in service and satisfy specific documentary and attestation requirements applicable to the type of facility (discussed below).

Under the new approach, there will be an initial application period (as yet unspecified), during which all applications will be evaluated at the same time. Allocations are awarded under a methodology that first allocates all available capacity within a given category (or sub-category) to facilities owned by certain prioritized groups (Ownership Selection Criteria) and/or facilities located in certain prioritized geographical areas (Location Selection Criteria).

The Ownership Selection Criteria prioritizes facilities owned by (i) Tribal Enterprises, (ii) Alaska Native Corporations, (iii) renewable energy cooperatives, (iv) certain tax-exempt entities (including US tax-exempts, state and local governments and agencies, Tribal governments and related entities, and rural energy cooperatives), and (v) certain renewable energy companies that serve

low-income communities and meet certain additional requirements.[9]

The rules include additional detail for the individual categories above. For instance, a renewable energy cooperative needs to own only 51 percent of the facility, is an entity that develops qualified solar and/or wind facilities and is either (i) a consumer or purchasing cooperative controlled by its members who are low-income households (as defined in section 48(e)(2)(C)) with each member having an equal voting right or (ii) a worker cooperative controlled by its worker-members with each member having an equal voting right.[10]

For a company to qualify as a renewable energy company for purposes of the Ownership Selection Criteria, it must be an entity that serves low-income communities and provides pathways for the adoption of clean energy by low-income households. The Proposed Rules list four additional requirements that the entity may also need to satisfy, including limitations on the types of permitted owners of the entity, annual gross receipts of less than $5 million for the previous year and fewer than 10 full-time employees, first installed or operated qualifying facilities at least two years earlier, and a minimum aggregate nameplate capacity of qualifying facilities installed or operated in low-income communities equal to 100 kW. However, it is unclear whether satisfaction of any or all of these requirements will be mandatory, as the rules provide that Treasury and the IRS are “considering” these requirements.[11]

Investors who are qualified tax-exempt entities appear to fare the best under these rules, as their facilities will receive priority treatment in the allocation process and they can claim the ITC and the bonus credit under direct pay and receive full value as a cash payment. More guidance will be needed to determine what structures, if any, could give priority allocation treatment to facilities financed by investors which do not appear to meet the prioritized ownership criteria. The issue is that

the rules do not define “ownership,” how to quantify indirect ownership percentages, or what percentage ownership is required for categories where no minimum ownership is required.

The Location Selection Criteria prioritizes facilities that will be placed in service in either (1) a Persistent Poverty County (PPC), meaning a county where 20 percent or more of the residents have experienced high rates of poverty over the past 30 years, or (2) a census tract designated as disadvantage by the Climate and Economic Justice Screening Tool (CEJST) because it is in at least the 65th percentile for low income and at least the 90th percentile for energy burden or PM2.5 exposure (which refers to certain airborne particulate matter).[12]

All applications with respect to facilities in a given category that satisfy at least one selection criteria (Priority Facilities) will receive allocations of the capacity limitation for such category during the initial application period unless the category is oversubscribed, in which case the priority allocation will be limited to Priority Facilities that satisfy both the Ownership Selection Criteria and the Location Selection Criteria. If there is any remaining capacity limitation, it will be allocated to the other Priority Facilities (i.e., those that satisfy only selection criteria), presumably pursuant to a lottery system. The rules provide that a lottery system may be used, but it is not clear what, if any, other methods might be used.

Similarly, for categories with enough capacity limitation to provide allocations to Priority Facilities, any remaining capacity limitation is generally available for allocation to the facilities that do not satisfy either selection criteria; again, using a lottery system if the category is oversubscribed. However, a minimum 50 percent of the original capacity limitation for a category is reserved for Priority Facilities and, to the extent less than that is allocated during the initial application period, it carries over

for allocation to Priority Facilities that submit applications after the end of the initial period.

There will be a rolling process for allocating any remaining capacity limitation after the end of the initial period. The rules lack much of the needed specifics regarding the operation of the rolling process. For instance, when and for how long will new applications be considered and how will allocation determinations be made during the rolling process? In addition, it is unclear whether an applicant with a facility that qualifies under more than one category could submit a second application for the facility under a different category during the rolling process. The Notice expressly precluded a second application during 2023, but the Proposed Rules are silent as to the effectiveness of any procedural rules in the Notice that are not expressly confirmed or changed.

Finally, the rules provide that Treasury and the IRS have discretion to reallocate capacity limitations across categories and sub-categories to maximize allocations in the event one category or sub-category is oversubscribed and another has excess capacity. Allocation decisions cannot be appealed.

Documentary and Attestation Requirements

As noted above, the applicable documentary and attestation requirements for each application vary depending on the characteristics of the facility because, according to the Proposed Rules, the requirements are designed to ensure that allocations are awarded to facilities that can be expected to be placed in service within four years and, therefore, mitigate the risk of awarding allocations to facilities that have to forfeit the allocation for failure to satisfy this requirement.

Applications with respect to:

- FTM facilities are required to include a copy of the executed interconnection agreement (IA), if

applicable, and attestations regarding (i) site control rights; (ii) required non-ministerial permits; (iii) compliance with applicable law; (iv) sizing of facility output sharing; and (v) installation site inspection.

- BTM facilities are required to include a copy of the executed purchase contract (PSA), lease or power purchase agreement (PPA), as applicable, a copy of the executed IA (for facilities larger than 1 MW AC), and attestations regarding (i) required non-ministerial permits; (ii) compliance with applicable law; (iii) appropriate facility sizing; and (iv) installation site inspection.
- Category 1 facilities are required to include documentation establishing satisfaction of the Ownership Selection Criteria, if applicable, and attestations regarding (i) location qualification; (ii) certain customer disclosures; and (iii) satisfaction of the Location Selection Criteria, if applicable.
- Category 2 facilities are required to include documentation establishing satisfaction of the Ownership Selection Criteria, if applicable, and attestations regarding (i) location qualification and (ii) certain customer disclosures.
- Category 3 facilities are required to include documentation establishing satisfaction of the Ownership Selection Criteria, if applicable, and attestations regarding (i) certain tenant disclosures and (ii) satisfaction of the Location Selection Criteria, if applicable.
- Category 4 facilities are required to include documentation establishing satisfaction of the Ownership Selection Criteria, if applicable, and attestations regarding (i) certain customer disclosures; (ii) the financial benefits and bill credit discount requirements; and (iii) satisfaction of the Location Selection Criteria, if applicable.

Interestingly, the Proposed Rules indicate Treasury and the IRS considered whether to require an application for an IA or an executed agreement and determined that an executed interconnection

agreement, when applicable, is essential to establishing sufficient project maturity.

Applicants that receive allocations have additional reporting requirements when the facility is placed in service:

- All applicants must report to the Department of Energy (DOE) and submit additional documents and attestations to confirm eligibility for the capacity limitation received.
- They must provide (i) attestation confirming there have been no material ownership or facility changes; (ii) documentary evidence establishing the placed-in-service date and location of the facility (e.g., permission to operate (PTO) letter or commissioning report for off-grid facilities); and (iii) documentary evidence from an unrelated third party verifying the facility's as-built nameplate capacity (e.g., PTO letter listing nameplate capacity).
- Applicants for Category 3 facilities must also provide a copy of a financial benefits sharing agreement between the building owner and the tenants, as well as a copy of a financial benefits sharing agreement between the facility owner and the building owner if the facility owner does not also own the residential building project.
- Applicants for Category 4 facilities must also provide (i) the final list of households served with name, address, subscription share, and income status of qualifying low-income households, including the verification method used, and (ii) a spreadsheet demonstrating the expected financial benefit to low-income subscribers and a minimum 20 percent bill credit discount rate.

Recapture

The Proposed Rules provide that the following circumstances result in a recapture event if the property ceases to be eligible for the increased ITC under Section 48(e):

- Property that is part of a part of a Qualified Low-Income Residential Building Project or a Qualified Low-Income Economic Benefit Project fails to provide financial benefits over the five-year period after its original placed-in-service date.
- Property that is part of a Qualified Low-Income Residential Building Project ceases to allocate the financial benefits equitably among the occupants of the dwelling units, such as not passing on to residents the required net energy savings of the electricity.
- Property that is part of a Qualified Low-Income Economic Benefit Project ceases to provide at least 50 percent of the financial benefits of the electricity produced to qualifying households, as described under Section 48(e)(2)(C)(i) or (ii), or fails to provide those households the required minimum 20 percent bill credit discount rate.
- For a property that is part of a Qualified Low-Income Residential Building Project, the applicable residential rental building ceases to participate in a covered housing program or any other housing program described in Section 48(e)(2)(B)(i), if applicable.
- A facility increases its output such that the facility's output is 5 MW AC or greater, unless the applicant can prove that the output increase is associated with a "new" facility under the 80/20 Rule (based on the cost of the new property plus the value of the used property).[13]

Conclusion

The Proposed Rules provide a great deal of detailed guidance and information needed by stakeholders seeking to obtain allocations of the capacity limitation for 2023 and be eligible to claim the low-income community bonus tax credit under Section 48(e). The rules also leave many questions unanswered.

A key issue facing developers and investors seeking to claim the bonus credit for projects placed in

service in 2023 is that the program will only provide allocations to facilities not yet placed in service. It is June and stakeholders still do not know when the program will start accepting applications or how long it will take to receive notification of allocations once the program starts accepting applications. The Proposed Rules are helpful to developers and investors with respect to facilities that can now be identified as qualifying for preferential treatment under either the ownership or location criteria, as the criteria are objective and specific and, for the most part, would likely enable parties to make reasonably informed evaluations about the likelihood of receiving an allocation. For everyone else, it appears the allocation will be based on a lottery system, making it difficult to know with any certainty whether the facility will be able to claim a low-income bonus ITC even if it is a qualifying solar and wind facility.

Further guidance on ownership and other topics in responsive to comments, as wells as start and end dates for the initial application period, will be important. Written or electronic comments must be received by June 30, 2023. Electronic comments are encouraged and can be submitted via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG–110412–23).

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[1] REG-110412-23. The release was in advance of the proposed rules published in the Federal Register on June 1, 2023. 88 FR 35791, also available at https://www.federalregister.gov/documents/2023/06/01/2023-11718.

[2] Unless otherwise stated, capitalized references to "Section" are to the applicable section of the Internal Revenue Code of 1986 (Code) or the Treasury regulations promulgated under the Code (Regulations).

[3] Section 48(e)(4)(C) provides a total 1.8 gigawatts (GW) of direct current (DC) capacity limitation for each of 2023 and 2024.

[4] The Notice describes the program's broad goals as being:

> to increase adoption of and access to renewable energy facilities in low-income and other communities with environmental justice concerns; encourage new market participants; and provide social and economic benefits to individuals and communities that have been historically overburdened with pollution, adverse human health or environmental effects, and marginalized from economic opportunities.

[5] Section 48(e)(2)(A)(iii)(I).

[6] Id.

[7] Section 48(e)(2)(B).

[8] Section 48(e)(2)(C).

[9] Explanation of Proposed Rules, Section II, C. 1.

[10] Explanation of Proposed Rules, Section II, C., 1., c.

[11] Explanation of Proposed Rules, Section II, C., 1., d.

[12] Explanation of Proposed Rules, Section II, C., 2. See also, https://screeningtool.geoplatform.gov/en/#3/33.47/-97.5. The CEJST website provides further detail. See also Methodology & data - Climate & Economic Justice Screening Tool (geoplatform.gov).

[13] See Rev. Rul. 94-31, 1994-1 C.B. 16.

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