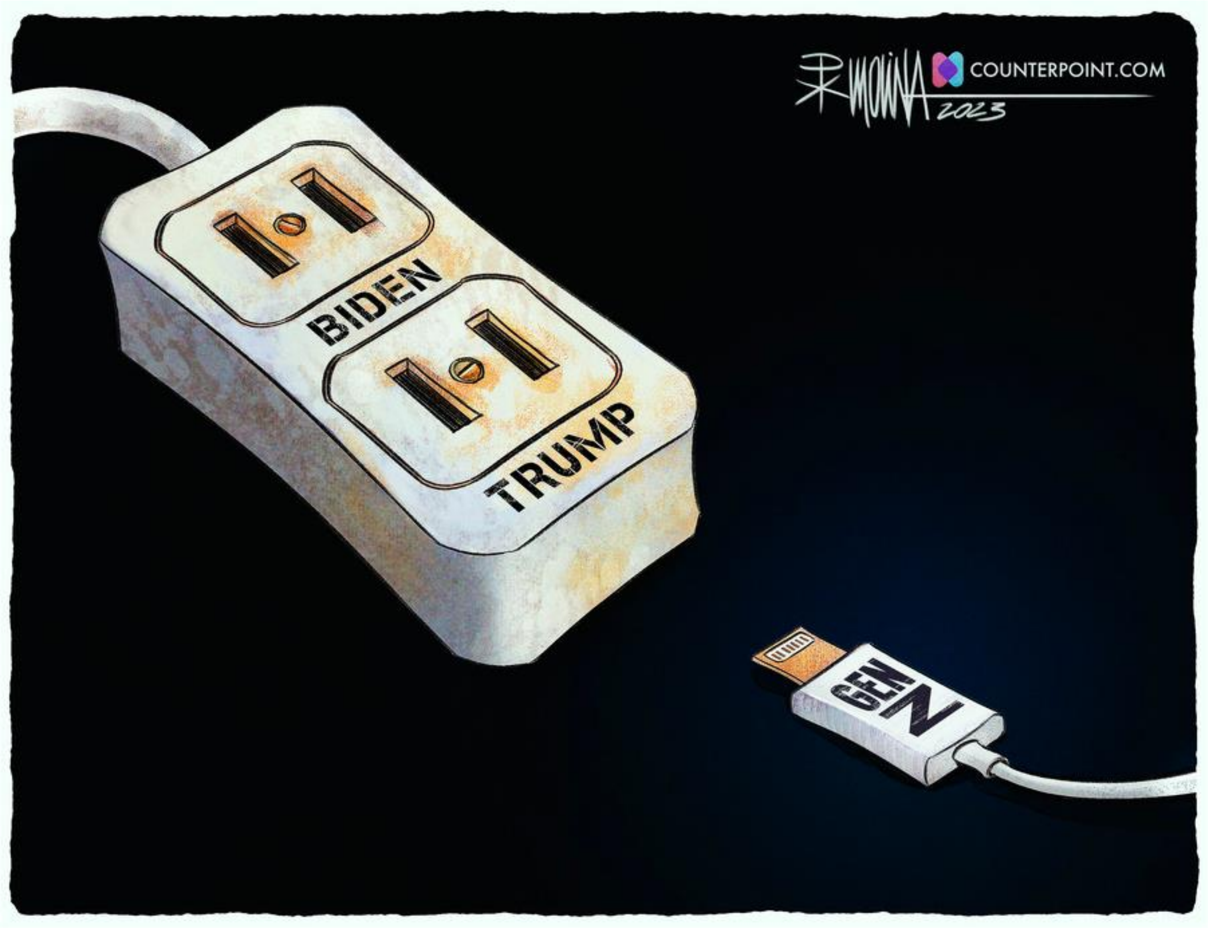
Direct-Pay Structures

Keith Martin

keith.martin@nortonrosefulbright.com

NORTON ROSE FULBRIGHT


COUNTERPOINT.COM
2023
BIDEN
TRUMP
GEN
Z

The IRA is a long statute, but it distills to two basic points.

The government will fund a <u>large</u> share of the cost of new renewable energy facilities. Project owners will receive tax credits worth as much as 70% of the project cost. Manufacturers of wind, solar and storage equipment and producers of a long list of minerals will also receive significant subsidies.

Here is how the math works for project owners:

- **30% base tax credit**
- **10% for domestic content**
- **10% for energy communities**
- **10% to 20% for LMI**

Here is how the math works for solar manufacturers:

- **4¢/watt for solar cells**
- **$12/m^2 for wafers**
- **$3/kg for polysilicon**
- **40¢/m^2 for polymeric backsheets**
- **7¢/watt for solar modules**
- **87¢/kg for torque tubes**
- **$2.28/kg for structural fasteners**

The subsidies will remain in place for a long time. The tax credits for owners will not start phasing out again until two years past the year greenhouse gas emissions from the US power sector fall at least 75% from 2022 levels. That will not happen before 2034 at the earliest.

Many people have been asking whether the Inflation Reduction Act could be rolled back. The answer is no before 2025 and probably no after that.

The House vote April 26 to repeal most of the IRA as part of a debt ceiling bill is not being viewed by the market as a "proposed change in tax law."

Another frequent question is whether the government might cap the tax credits. There is no precedent for that. The Congressional Budget Office rescored them on April 25 at $569.5 billion, more than double the original $271 billion estimate.

The Treasury hopes to issue guidance about the direct-pay provisions by June 21. They will take the form of proposed regulations rather than a notice.

Here are the issues we have run into while trying to position projects to benefit from direct pay.

Compliance with domestic content rules is mandatory to be able to receive a full direct payment for projects on which construction starts in 2024 or later. Waivers are possible, but the Treasury will have to explain the process.

Use of US-made equipment construction materials or manufactured products is waived to the extent it increases the overall construction cost by more than 25% or the items are not available in sufficient quantity or quality.

The biggest issue awaiting guidance is when the election can be made and how long it will take the IRS to review the application and make a payment. The payment is a tax refund, but does not require review by the Joint Committee on Taxation refund counsel.

Another issue is whether state colleges and other "instrumentalities" qualify for direct payments.

Private developers have been looking for ways to qualify for direct payments by involving tax-exempt or government entities in their transactions, including by leasing the project to a state or local government entity, electing to pass through the investment tax credit on the project and letting the lessee claim a direct payment.

The Senate Finance Committee staff told us inverted leases do not work. A structure that would clearly work is to draft a power purchase agreement to sell electricity to a government or tax-exempt entity -- for example, a CCA in California -- so that it is treated as an installment sale of the project. The CCA will be the tax owner from the start.

A joint venture between a tax-exempt or government entity and a private party probably does not work. The only such structure with which the tax bar is comfortable until guidance says otherwise is a tenancy-in-common structure.

The longer the direct payments take, the more interest there will be in bridge loans. Projects on which PTCs will be claimed may require annual direct-payment applications. Advance rates of between 50% and 85% are under discussion with banks. A bank foreclosure could lead to recapture and an obligation to repay the unvested tax credits to the Treasury.

State and local governments should compare ownership with merely buying the electricity and sharing in the greater tax benefits that a private owner would receive indirectly through a reduced electricity price.

With direct pay, the government can tap cheaper debt and receive 100¢ on the dollar for the tax credit, but at a cost of foregoing the depreciation on the project and probably also foregoing a basis step up for calculating the tax credit (unless an inverted lease works.

The direct payment is increased by 6.0445% to offset the effects of federal budget sequestration.

NORTON ROSE FULBRIGHT

With private ownership, the government can benefit indirectly not only from depreciation, but also from a basis step up for calculating both any investment tax credit and depreciation. Tax-exempt debt used to be worked into the structure by using a prepaid power contract, but this has been harder to do since 2017.

A state or local government entity has other options. It can sell the tax credits or enter into a traditional tax equity arrangement as an alternative to a direct payment by forming a blocker corporation to own the project. It would have to elect out of tax-exempt controlled entity status. There have been questions about whether a "super" tax-exempt can make such an election, but the current IRS view is yes.

Tax credits have been trading in the direct-sale market at between 90¢ and 92¢ on the dollar. Prices are expected to increase over time.

Average number of hours per week Gen Z-ers say they spend helping older colleagues locate computer files:

8

Percentage of conversations that end when both parties want them to:

2%

Some headlines write themselves:

Distillers of Gin Infused with Elephant Dung Insist Product Isn't Crap

Direct-Pay Structures

Keith Martin

keith.martin@nortonrosefulbright.com