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Tax Credit Alert

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New opportunities for renewable energy tax credits on low-income developments

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This alert provides a brief overview of the 20% "adder" that can apply to renewables facilities on affordable housing projects.

What's the Impact?

- In addition to the normal 30% ITC, the Inflation Reduction Act offers a 10 or 20 percentage point increase for renewable energy projects connected to low-income areas or on certain residential rental buildings, but this "adder" must be applied for and receive an award
- IRS Notice 2023-17 provides guidance about how the rules will be applied, but the timing of applications and awards may affect a project's ability to qualify for both LIHTCs and ITCs.
- Be on the lookout—more guidance is coming.

The Inflation Reduction Act of 2022 provides a broad range of new incentives for renewable energy projects. Many are built around the 30% investment tax credit (ITC), with 10 or 20 percentage point "adders," which can increase the ITC rate to as high as 70%. One of the new adders provides an adder for certain projects that have connections to low-income communities or qualified low-income residential buildings. Now, in IRS Notice 2023-17 the IRS has given its first guidance about the low-income-related adders.

The basics

Let's start with the basics. The normal investment tax credit (ITC) for renewables is 30%, presuming that the project is one or more of the following: (i) under a megawatt, or (ii) pays prevailing wages and hires apprentices in accordance with IRS and DOL requirements, or (iii) began construction before 1/29/23. Solar on most housing projects passes the under 1MW test; we'll presume that's true here. So, as a "base," a $100,000 solar facility can qualify for a $30,000 tax credit.

The adders

From that base 30%, the new 2022 Inflation Reduction Act provides adders, as briefly described above. There is a 10% increase for using American components and another 10% for projects in certain "energy communities" (this includes brownfields, areas with high oil, gas, or coal employment as well as an above average unemployment rate, and census tracts in which a coal mine closed after 1999 or a coal-fired generator was retired after 2009). Finally, there ***can*** be ***awards*** of another 10% or 20% for projects in low-income communities or on certain low-income buildings. This last adder (the one that applies to low-income communities and buildings) has the somewhat lengthy name of "***the environmental justice solar and wind capacity limitation***." To be clear, this is a one sentence summary of how some incredibly complex tax provisions operate. Most, if not all, of these provisions need significant IRS guidance before we can tell you whether and how a particular project qualifies and how the adder can be claimed.

For example…

If one or more of these provisions applies to a project, it might qualify for a 40%, 50%, 60%, or (in some cases) a 70% energy credit. It may even be possible for the same expenditure to qualify for ***both*** a 4% or 9% (times ten years) low-income housing tax credit (LIHTC) and ***also*** a 30–70% energy ITC. For example, a $100,0000 solar facility at a 4% LIHTC housing project that uses American solar panels and ALSO is awarded a 20% adder might qualify for 10 times 4% (or $40,000) in LIHTC, plus 60% in renewable energy credits (or $60,000), a total of the full 100% of its cost. Note that the IRA repeals the rule that used to require a basis adjustment (and therefore a reduced LIHTC) if a project claimed both the energy ITC and LIHTC. Now the full cost of the project can qualify for both credits.

Notice 2013-17

The most recent guidance from the IRS on these adders is Notice 2023-17. It discusses the environmental justice solar and wind capacity limitation that provides a 10%–20% adder to certain projects in low-income communities. Note that while the domestic content and energy community adders are "automatic" (and expected to be covered by other guidance that has not yet been published), the low-income adder is different: ***it must be applied for and awarded***. And, ***it only applies to solar and wind***.

Drawing from the applicable Code provision, the IRS notice says that in 2023, the IRS will award the 10–20% low-income adder to solar and wind projects that are under 5 MW in size, that the total of these adder awards for 2023 will be for a total of 1800 MW of projects, and that of that 1800 MW total, 200 MW will be awarded to solar or wind projects on, or part of, "qualified low-income residential building projects" (like buildings benefitting from LIHTC). The IRS indicated that it plans to accept applications for solar and wind projects associated with low-income residential buildings in the third quarter of 2023, and that awards will not be given to solar or wind projects that are already in service. Another part of the notice calls for a lottery to award the additional percentage if the awards are over-subscribed.

Finally, the Notice says that more guidance is coming. Plainly, more guidance is needed. Aside from providing an application process, there are rules in the Code that need explanation before taxpayers will know how to qualify for the adder. In particular, the Tax Code provision providing the 20% adder for qualified residential low-income buildings requires that the financial benefits of the electricity produced be "allocated equitably" among the occupants of the building, a requirement that is not otherwise defined or explained.

Reaction

The provision denying awards to energy projects that are already in service and the provision calling for a lottery if the awards are over-subscribed appear to encourage a developer to keep its solar or wind facility out of service awaiting the possibility of receiving an award. This may limit the utility of this add-on, depending on the particular facts.

Section 42

For the Section 42 LIHTC, projects often face a year-end deadline to get the facility placed in service. This is so that costs can be included in "eligible basis" at the end of the first year of the credit period. Costs of facilities placed in service in subsequent years generally do not increase LIHTC eligible basis, meaning that they don't qualify for low-income housing tax credits.

As noted above, the housing credit is worth 4% x 10 years or 9% x 10 years, i.e., 40% or 90% of the project's cost. The cost of the solar or wind facility should be eligible for these credits, assuming that the facility meets LIHTC requirements. In general, this would require the facility to be a "common area facility" for which there is no additional charge, or electricity could be provided free to tenants. Of course, the energy project could just be used to generate and sell electricity, and not qualify for the LIHTC.

Section 48

On the energy side, the project should qualify for the 30% "base" renewable energy credit, but it will have to apply for and receive an award of the 20% adder. If it wins an award, then it will get a 50% credit. The energy facility doesn't have to qualify for the LIHTC in order to qualify for energy credits, but remember that the provision providing the 20% adder for projects on residential rental buildings requires that the financial benefits of the electricity produced must be "allocated equitably" among the occupants. As noted above, we don't have guidance on how that requirement can be met.

Combining Section 42 and Section 48

If the IRS (i) isn't seeking applications until the 3rd quarter, (ii) will have a lottery if it gets too many applications, and (iii) won't give awards to solar or wind facilities that have already been place in service, then developers planning to place their facility in service this year and trying to get ***both*** credits may be faced with a hard decision: Should I take the 4% or 9% LIHTC (which is 40% or 90% over the 10-year credit period) and the 30% base ITC for renewables, or should I delay the placed-in-service date for the solar or wind facility in the hopes of getting the 20% adder to the renewable credit while potentially losing the 40% or 90% LIHTC that would otherwise apply to the renewables project if I don't place the energy facility in service until after the first year of the LIHTC credit period? At this point, with only the preliminary guidance of Notice 2023-17 (and no actual forms or process for awarding the adder) it is hard to recommend a course of action. Of course, the decision is not hard for projects that will be placed in service ***next year;*** they can hold off placing everything in service, and not risk any of the LIHTC. Regardless, to claim both credits, the solar or wind facility will have to comply with the "allocated equitably" requirement, described above.

What does this mean?

The bottom line is that these are quite favorable provisions that would increase the subsidy for solar and wind on housing projects, but we continue to need more guidance before we will know how a project applies for the adder and when and how likely it is to get an award.

Other relevant provisions of the IRA

As we noted above, these are complicated rules, and there are many other new and expanded provisions that are part of the new law. In addition to the adder rules we described above, there are expanded rules to subsidize energy improvements to buildings by providing accelerated deductions (Section 179D) and another investment credit (Section 45L); there are also provisions to provide continuing (and in some cases, new) credits for other forms of energy, such as geothermal, hydrogen, and others; and there are also new rules to provide credits for "stand alone" energy storage, and allowing taxpayers to take a cents per kilowatt hour "production tax credit" (instead of the ITC) for solar. Significantly, many energy credits now have an additional option not available to other credits: as an alternative to allocating them among partners, many renewable energy credits can now be ***sold*** (without the need for a partnership or LLC and the admission of investors).

What's on the horizon?

The IRS has been diligent and sought taxpayer input. Unfortunately, on account of more than 270 pages of new Code provisions and ***more than 6000 pages of comments and requests*** submitted to the IRS, there continues to be little guidance on how many of these rules will work.

So, for example, there is the potential timing issue we described above for the 20% adder. And, for many situations, we can't tell you something as fundamental as "What forms do I fill out?" Or "Can individuals use purchased tax credits, or are they generally limited by the passive activity rules?" Fortunately, some of these provisions ***do*** have guidance, and for others, there is lots of guidance coming, as well as helpful talk in the industry. We've been paying good attention to IRS notices and other helpful information as it appears, and we are also active in trade associations devoted to renewable energy credits.

We'd be pleased to speak with you about what we know today about these rules, what we are expecting, and what the timing looks like.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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