IRS Releases New Proposed Rules for the Low-Income Communities Bonus Credit for the Investment Tax Credit

ALERTS

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Overview

On May 31, 2023, the Department of Treasury (Treasury) and Internal Revenue Service (IRS) released proposed rules that set forth application and eligibility criteria for the ***low-income communities bonus credit investment program*** (Low-Income Communities Bonus Credit Program or Program), which increases the amount of the Investment Tax Credit (ITC) under Code Section 48(a) as authorized under the Inflation Reduction Act of 2022 (IRA) for certain small wind, solar, and energy storage technology installed in connection with those facilities. These proposed rules provide important proposed clarifications to how the application process will function and what facilities will be eligible for the Program. The intent is for the proposed rules, once finalized, to apply to applicants for the 2023 capacity allocation and to inform future allocation years, including pursuant to Code Section 48E(h).

Overview of the Low-Income Communities Bonus Credit Program

- *Why Is There an Application?* The Low-Income Communities Bonus Credit Program, unlike the other bonus credits applicable to the ITC such as domestic content (see Wilson Sonsini client alert here) or energy communities (see Wilson Sonsini client alert here), is a ***"capped"*** or ***"allocated"*** bonus credit that requires an application and must be approved. Only a total of 1.8 gigawatts of direct current capacity for each calendar year will be awarded this additional incentive and the application process governs how the Treasury and IRS will determine which taxpayers receive allocations of such capacity allocation for specific facilities.
- *What Projects or Facilities Are Eligible?* Eligible facilities for the Program are those that generate electricity solely from a wind facility, solar energy property, or small wind property, have a maximum net output of less than 5 megawatts (MW) as measured in alternating current (AC), and fall into one of four categories (Categories) generally applicable to low-income oriented projects. Projects must be placed in service within four years after the applicant successfully receives a capacity allocation and may ***not*** be placed in service before the taxpayer has been awarded an allocation. Only "owners" of the facilities may apply (more on this below). Those Categories and their corresponding capacity allocations and additional bonus credit percentage value are:

Category Number	Title	Capacity Allocation	Bonus Credit Value	Short Definition
Category 1	Located in a Low-Income Community	700 MW	10%	The facility must be in a low-income community as defined by certain census tract income metrics.
Category 2	Located on Indian Land	200 MW	10%	The facility must be located on federally recognized Indian land.
Category 3	Qualified Low-Income Residential Building Project	200 MW	20%	The facility must be installed on a residential rental building that participates in an affordable housing program, as defined in the Violence Against Women Act of 1994, Housing Act of 1949, Native American Housing Assistance and Self-Determination Act of 1996, and other affordable housing determined by the Secretary, and the "financial benefits" of the electricity produced by such a facility are allocated equitably among the occupants of the dwelling units of such building.
Category 4	Qualified Low-Income Economic Benefit Project	700 MW	20%	Taxpayer must ensure that at least 50% of the “financial benefits” of the electricity produced by the eligible facility are provided to households with income of less than 200% of the poverty line applicable to a family of the size involved, or less than 80% of area median gross income.

- *How Much Is the Additional Credit?* Taxpayers may “stack” multiple bonus credits for these types of facilities, providing up to a maximum 70 percent ITC (e.g., for Category 3 and 4 projects that also satisfy domestic content and energy community requirements), thereby providing a substantial federal tax incentive for these smaller wind, solar, and combined energy storage projects that benefit low-income communities as described in the proposed rule.

Summary of the Proposed Rule

The proposed rules supplement the guidance provided in Notice 2023-17 to outline the specific application procedures, additional allocation criteria, and applicable definitions, among other information required to submit an application to request an allocation of the capacity limitation (Capacity Limitation) in 2023 across the four Categories. The guidance indicates that Treasury and IRS expect to issue final rules for the 2023 application cycle via regulations later this year and seeks comments regarding the proposed rules, which must be submitted by June 30, 2023. Comments can be submitted on the ***Regulations.gov*** portal at this link.

The proposed rules do the following:

- *Existing Aggregation Rules Apply:* The proposed rule defines "facility" based on single project factors. Treasury notes that it is "concerned that some applicants may attempt to circumvent the less than 5-megawatt output limitation…by artificially dividing larger projects into multiple facilities." Accordingly, the ***proposed rule provides that previously defined aggregation factors apply***. Specifically, the factors provided in Section 7.01(2)(a) of Notice 2018-59, 2018-28 I.R.B. 196 or Section 4.04(2) of Notice 2013-29, 2013-20 I.R.B 1085, apply. These factors include, but are not limited to: 1) whether the energy properties are owned by a single legal entity; 2) whether the energy properties are constructed on a contiguous piece of land; 3) whether the energy properties are described in a common power purchase agreement or agreements; 4) whether the energy properties have a common intertie; 5) whether the energy properties share a common substation; 6) whether the energy properties are described in one or more common environmental or other regulatory permits; 7) whether the energy properties were constructed pursuant to a single master construction contract; and 8) whether the energy properties were financed pursuant to the same loan agreement.
- *Energy Storage:* Standalone energy storage property is not an eligible facility for purposes of the Program. However, the IRA states that energy storage technology installed "in connection with" a wind facility, solar energy property, or qualified small wind energy property is eligible. The proposed rule defines "in connection with" based in part on some of the aggregation factors mentioned immediately above. The proposed rule would define "installed in connection with" other eligible property if both: ***1) the energy storage technology and other eligible property are considered part of a single qualified solar and wind facility because the energy storage technology and other eligible property are owned by a single legal entity, located on the same or continuous pieces of land, have a common interconnection point, and are described in one or more common environmental or other regulatory permits; and 2) the energy storage technology is charged no less than 50 percent by the other eligible***

property. The rule also proposes to add a safe harbor, deeming energy storage technology to be charged at least 50 percent by the connected facility if the power rating is less than two times the capacity rating of the connected wind facility (in kWac) or solar facility (in kWdc).

- *Category 3 and 4 "Financial Benefit":* The proposed rule defines the terms "financial benefit" and "electricity acquired at a below market rate" as well as a manner to apply such definitions to Category 3 facilities that are part of a qualified low-income residential building project and Category 4 facilities.
    - <u>Category 3 (Low-Income Housing)</u>: The proposed rules state that "financial benefit" can be demonstrated through "net energy savings." At least "50% of the financial value of net energy savings would be required to be equitably passed on to building occupants…The Treasury Department and the IRS propose to reserve allocations…exclusively for applicants that ***would equitably pass net energy savings by distributing equal shares among the qualified residential property's units that are designated as low-income under the covered housing program, or by distributing proportional shares based on each dwelling unit's electricity usage.***" Further, the proposed rule notes that the facility may be ***third-party owned or commonly owned with the building***. The proposed rules define the financial value of net energy savings differently depending upon whether the facility and qualified residential property have the same or different ownership:
        - *Same Ownership:* In scenarios where the facility and the qualified residential property have the same ownership, the proposed rules define "net energy savings" as the financial value equal or greater to 1) 25 percent of the gross financial value of the annual energy produced or 2) the gross financial value of the annual energy produced minus the annual costs to operate the facility. Gross financial value is further defined.
        - *Different Ownership:* In scenarios where the facility and the residential property have different ownership and the facility enters into a power purchase agreement (PPA) or energy services contract with the residential property owner, the proposed rule defines "net energy savings" as equal to the greater of "(1) 50% of the financial value of the annual energy produced by the facility which accrues to the owner of the qualified residential property in the form of utility bill credit and/or cash payments for net excess generation or (2) the financial value of the annual energy produced by the facility which accrues to the owner of the qualified residential property in the form of utility bill credit and/or cash payments for net excess generation minus any payments made by the building owner to the facility owner for energy services associated with the facility in a given year." In these scenarios, the "facility owner must enter into an agreement with the building owner for the building owner to distribute savings to residents."

Regardless of ownership, residential buildings may have master-metered or sub-metered utilities. Financial benefits cannot be distributed in the same way in these scenarios. For sub-metered buildings, tenants must receive the financial value associated with utility bill savings in the form of a credit on their utility bills in accordance with existing guidance from the Department of Housing and Urban Development (HUD). In states where such utility bill savings are not permitted, Treasury requests comments on how to issue financial benefits. For master-metered buildings, the proposed rules require that the building owner must pass on the savings through other means, such as by providing certain benefits to the building residents beyond those provided prior to the qualified solar and wind facility being placed in service. Here, equally, HUD has issued guidance for how residents of master-metered HUD-assisted housing can benefit from owners sharing financial benefits accrued from an investment in solar energy generation, which the proposed rules suggest taxpayers follow.

  - <u>Category 4 (Low-Income Benefit Projects)</u>: A facility must serve multiple households and at least 50 percent of the facility's total output must be distributed to qualifying low-income households. Allocations will be exclusively reserved for those that would provide at least a 20 percent bill credit discount rate for all such households. "Bill credit discount rate" is defined as the difference between the financial benefit distributed (including bill credits, and other incentives the household is eligible for) and the cost of participating in the program (including subscription payments for renewable energy). Verification of households' qualifying low-income status is required, utilizing categorical eligibility or other income verification methods. "Categorical eligibility" can include proof of participation in a needs-based Federal, state, tribal, or utility program within the applicable income limits. Importantly, applicants cannot rely on self-attestations of the households.

- *Location in Low-Income Community or on Indian Land:* Defines "located in" for the purposes of Category 1 and 2, as well as for Additional Selection Criteria (discussed below), by utilizing the "Nameplate Capacity Test." The Nameplate Capacity Test states that a facility is considered located in or on the relevant geographic area 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 energy-generating units that are located in the qualifying area by total nameplate capacity of all the energy-generating units of the facility. Solar should use direct current for nameplate capacity, otherwise it should be in alternative current (e.g., for wind). Any energy storage technology installed in connection with the solar or wind facility does not impact the Nameplate Capacity Test.

- *Prior Placed-in-Service Rule:* The proposed rule reiterates initial guidance provided in Notice 2023-17 that facilities that are placed in service prior to the allocation process are not eligible and that facilities receiving a capacity allocation must be placed in service within four years of receiving the Capacity Limitation.

- *Application Process:* The proposed rule outlines reservations of Capacity Limitation allocation for applicants that meet certain additional selection criteria, and notably, changes course from the guidance set forth in Notice 2023-17.
  - Initial Application Window: Applications received by a certain time will be evaluated together, followed by a rolling application process if the Capacity Limitation is not allocated after this initial window.
  - Overall Priority Given to Certain Applicant Facilities Meeting Additional Selection Criteria: Facilities that meet at least ***one*** of the categories of specified ownership and geographic criteria (Additional Selection Criteria) would receive priority during the initial application window for an allocation within each facility category. ***At least*** 50 percent of the total Capacity Limitation within each category would be reserved for facilities meeting at least one of the Additional Selection Criteria.
  - Priority Assigned by Number of Additional Selection Criteria Satisfied: Priority is generally assigned first to applicants that meet at least one of the Additional Selection Criteria in the initial application window. However, if essentially all applicants meet at least one of these criteria, such that the Capacity Limitation is met by applicants meeting one Additional Selection Criterion, then priority is assigned to only those meeting ***two*** Additional Selection Criteria.
  - Lottery System: A lottery system may be used in oversubscribed categories to decide among similarly situated applicants. No administrative appeal allowed.
  - Treasury and IRS Discretion: Discretion retained to reallocate Capacity Limitation across categories and sub-categories in event one category is oversubscribed and another has excess.
  - Additional Selection Criteria, Defined:
    - *Ownership Criteria:* A facility will meet an Additional Selection Criteria if it meets the "Ownership Criteria." "Ownership Criteria" is met if the facility is owned by a Tribal Enterprise, Alaska Native Corporation, renewable energy cooperative, ***qualified renewable energy company meeting certain characteristics***, or a qualified tax-exempt entity. Disregarded entities such as limited liability companies (LLCs) are not the owners—only the applicant, not the disregarded entity, is treated as the owner for purposes of establishing Ownership Criteria. Tribal Enterprise, Alaska Native Corporation, and renewable energy cooperative are further defined. Notably, a "Tribal Enterprise" is one owned either directly or indirectly (through a wholly owned corporation under its Tribal laws or through a section 3 or 17 Corporation) at least 51 percent by an Indian Tribal government (e.g., a federally recognized government) where the Indian Tribal government has the power to appoint and remove a majority of the individuals serving on the entity's board of directors or equivalent governing board. "Qualified renewable energy company" for this purpose is an entity "that serves low-income communities and provides pathways for the adoption of clean

energy by low-income households." In addition to this general business purpose, Treasury and the IRS are considering other requirements to satisfy being a "qualified renewable energy company," including 1) at least 51 percent equity interests owned and controlled by one or more individuals, a Community Development Corporation, certain co-ops, or certain tribal governments and organizations; 2) after applying controlled group rules, having less than 10 full-time equivalent employees and less than $5 million in annual gross receipts in the prior calendar year; 3) having first installed or operated a qualified solar or wind facility two or more years prior to the date of application; and 4) having installed or operated facilities with at least 100kW of cumulative nameplate capacity located in one or more low-income communities. Treasury and the IRS are specifically requesting comments on these proposed requirements, as well as an administrable rule to ensure that qualified renewable energy communities are employing workers in the low-income communities.

  - *Geographic Criteria:* A facility will meet an Additional Selection Criteria if it meets the "Geographic Criteria." "Geographic Criteria" is defined as being located in a Persistent Poverty County (PPC) or census tract designated by the Climate and Economic Justice Screening Tool (CEJST) that is disadvantaged based on whether the tract is either greater than or equal to the 90th percentile for energy burden and is greater than or equal to the 65th percentile for low income or greater than or equal to the 90th percentile for PM2.5 exposure and is greater than or equal to the 65th percentile for low income. PPC is a county where 20 percent or more of residents have experienced high rates of poverty over the past 30 years. The U.S. Department of Agriculture has PPC guidance in place that Treasury proposes to use. Notably, applicants who meet the Geographic Criteria at the time of application will not be subject to recapture unless the facility is physically moved outside of the applicable geographic area.

- *BTM Sub-Reservations:* Treasury anticipates Category 1 will receive the most applications. Therefore, Treasury proposes to sub-divide the 700 MW allocation with 560 MW reserved specifically for residential behind the meter (BTM) facilities, including rooftop solar. The remaining 140 MW will be available to front of the meter (FTM) projects and non-residential BTM facilities. BTM projects are defined as those that are connected with an electrical connection between facility and panelboard or sub-panelboard of the site where it is located, is to be connected on the customer side of the meter, and the primary purpose is to provide electricity to utility customer. This also includes systems "not connected to a grid that may not have a utility service meter, and whose primary purpose is to serve the electricity demand of the owner." It is not clear from the proposed rules whether the Additional Selection Criteria will apply at the overall level of Category 1, or be further sub-divided between these sub-divisions.

- *Application Materials:* The proposed rules set forth required documentation and attestations at the time of application as well as when a facility that has received an allocation is placed in service.

- *Disqualification and Recapture:*
  - Treasury and the IRS recognize that circumstances may change during the four-year period post-allocation and prior to a project being placed in service, which in some cases could result in a project no longer being eligible for the allocation it received. To promote an efficient allocation process, Treasury and the IRS want to discourage material changes in project plans and thus propose that any facility that received an award will be disqualified from receiving that allocation if, prior to or upon the facility being placed in service: 1) the location of the facility changes; 2) the nameplate capacity increases to be in excess of the 5 MW limitation or decreases by the greater of 2 kW or 25 percent of the capacity limitation awarded in the allocation; 3) the facility no longer satisfies the financial benefits requirements as planned; 4) the facility is not placed in service within 4 years of the award notification; or 5) subject to certain limited exceptions, the facility received an allocation based in part on the "Ownership Criteria" described above and there has been a change in ownership.
  - With respect to recapture, the period and percentage of recapture is determined under rules similar to Code Section 50(a). Such recapture may not apply to any property if, within 12 months after the date the applicant becomes aware or reasonably should have become aware of such property ceasing to be eligible for such Code Section 48(a) increase, the eligibility is restored. This restoration increase is not available more than once with respect to any facility. Proposed recapture events include (as applicable): 1) the project fails to deliver financial benefits over the 5-year period after its original placed in service date; 2) the project ceases to allocate financial benefits equitably among dwelling units; 3) the project ceases to provide at least 50 percent of financial benefits of electricity to qualifying households or fails to provide the minimum bill credit; 4) the residential rental building the facility is a part of ceases to participate in a covered housing program; and 5) the facility increases its output to over the 5 MW threshold, unless the increase is due to a new facility being placed in service (taking into account the "80/20 rule," which provides that energy property may qualify as newly placed in service although it contains some used components of property, provided the fair market value of the used components is not more than 20 percent of the energy property's total value).

Key Takeaways

- *Category 1 and 2 Projects Can Be Sited on Commercial, Industrial, or Other Property*. The proposed Nameplate Capacity Test for Category 1 and Category 2 suggests that projects sited on commercial or industrial properties that serve the general public may qualify because the facility need only have 50 percent of its nameplate capacity located in the applicable geographic area, not serve specified persons. For example, projects sited on business property open to the public, a house of worship, or community center may qualify, provided they are located on an eligible census tract or Indian land, even if those establishments serve individuals who live outside of the applicable geographic area. Note that for Category 1, this is limited by the suballocation to residential BTM facilities.

- *Preference for Small Renewable Energy Companies:* The proposed rules consider giving priority to smaller solar and wind developers and owners, reflecting an intention to ensure that large residential and BTM solar and wind companies, who could on their own or collectively account for the annual Capacity Limitation allocation do not necessarily crowd-out smaller entities.

- *Geographic Based Eligibility Criteria Not Subject to Recapture:* Many developers have expressed concern over recapture risk if a facility received the bonus credit by virtue of the geographic eligibility changing over the course of the five-year recapture period (e.g., a census tract was eligible in the first year, then the poverty metrics improved and in the third year the facility was no longer considered eligible). The proposed rules have clarified that as long as eligibility is met at the time of application and the facility does not physically move, these facilities will not be subject to recapture if the underlying applicable geographic metrics change, such as the overall poverty rate.

- *Calculation of "Net Energy Savings" Requires Careful Coordination and Consideration with Other Federal Utility Bill Incentives.* Taxpayers who plan to pursue a capacity allocation for Category 3 and Category 4, under which these rules propose that "financial benefit" can be demonstrated through "net energy savings," should be cognizant of the array of state and local laws governing metering and billing requirements applicable to consumer energy bills. Whether and to what extent Category 3 and 4 properties are subject to master-metering versus sub-metering varies by state and, often, by locality within a given state. Similarly, the rules governing what can be included on consumer energy bills—and whether and how energy savings can be passed through to consumers—is a matter of state and local law, as Treasury recognized in seeking further comment on how financial benefits may be passed through to consumers in states that do not allow on-bill credits. In the same vein, taxpayers planning to pursue Category 3 and Category 4 capacity allocations should be aware of how other federal programs available to low-income families and individuals that offset or subsidize utility costs, such as the Low Income Home Energy Assistance Program (LIHEAP), HUD subsidized housing utility bill reimbursement programs, and others, may introduce complexity into demonstrating "net energy savings." Eligibility overlaps for these federal programs and the Category 3 and 4 allocation eligibility (e.g., thresholds of the federal poverty level [FPL]).

- *Categorical Eligibility Rule Creates Potential for Streamlining Income Verification for Category 3 and Category 4 Projects.* The proposed rules indicate that taxpayers may use "categorical eligibility" to demonstrate income verification for Category 3 and Category 4 projects. This term under federal law typically refers to the fact that low-income households and individuals are often eligible for multiple low-income programs where income is verified. To reduce duplication in income verification and administrative cost, once a household or individual is enrolled in a certain program or programs, such as the Supplemental Nutrition Assistance Program, this qualification can port over to make that same household or individual eligible for other programs without having to reproduce income verification, which is often burdensome and time consuming. By incorporating categorical eligibility criteria into the proposed rules, this may provide efficiencies for developers seeking a capacity allocation under Category 3 or Category 4 to provide proof of income verification because these other federal programs have similar income-verification thresholds.

- *Special Rule for Recapture Restoration:* Outside the carve-out of recapture for geographic location eligibility criteria, the rules provide that if the taxpayer becomes aware or reasonably should have become aware of property ceasing to be eligible for the bonus credit and the taxpayer works to restore eligibility within a 12-month period, recapture may not apply. This relaxing of recapture rules may provide regulatory relief or flexibility for developers who are working to place in service projects in Category 3 and Category 4 due to the complex and overlapping set of federal incentives for low-income households and calculations required to return net energy savings to these households.
- *Application Process:* As a reminder, prior Notice 2023-17 outlined that application submission cycles would run on 60-day windows by Category, but the new proposed rules indicate that this application process may change based on public feedback in response to Notice 2023-17. Exact timelines are not yet known but are expected in the final rule.

For more information, please contact Nicole Gambino, Nic Gladd, Jaron Goddard, Brandon King, Hershel Wein, or any member of the firm's energy and climate solutions practice.