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Client Alert
Commentary

Latham & Watkins Transactional Tax Practice

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IRS Clarifies Rules for Energy Community Bonus Tax Credits

The Notice enables developers and investors to more easily determine the Energy Community status of projects.

Key Points:

- The IRS and the Treasury Department have provided tables to assist in determining eligibility for energy community bonus tax credits, which set out metropolitan statistical areas (MSAs) and non-metropolitan statistical areas (non-MSAs); MSAs with historically significant fossil fuel employment; census tracts that meet the coal closure test; and a corresponding mapping tool.
- Offshore wind projects can qualify for energy community bonus tax credits if their onshore substation is located within an Energy Community.
- The methodology to determine historical fossil fuel local tax collections remains an open question.

On April 4, 2023, the IRS published Notice 2023-29 (the Notice) clarifying the requirements for claiming energy community bonus tax credits for renewable energy projects. The bonus credits were part of the Inflation Reduction Act of 2022 (the Act) and were designed to incentivize developers to locate new projects in communities with historical or current connections to the fossil fuel industry, referred to as energy communities (Energy Communities). The Act left open many of the details necessary to define the precise scope and definition of an Energy Community, which made it difficult for renewable energy developers and tax equity investors to rely on the availability of bonus tax credits. The Notice fills in many of the missing details and is expected to result in greater certainty regarding qualification for bonus Energy Community tax credits.

Energy Communities

The Act provides an additional tax credit for projects placed in service in 2023 or later that are placed in service or located in an Energy Community. Projects claiming an investment tax credit (ITC) can claim up to an additional 10% ITC if placed in service in an Energy Community, while projects claiming a production tax credit (PTC) may increase their PTCs by 10% if they are located in an Energy Community. Under the Act, an Energy Community includes an area with significant employment or tax revenue from the fossil fuel industry that also has significant recent unemployment; a brownfield site; or a census tract (or any adjacent census tract) where a coal mine or coal-fired power plant has recently closed.

Statistical Areas

A project qualifies as located in an Energy Community if it is located in an MSA or non-MSA that has, at any time since 2009, had at least 0.17% employment or 25% local tax collection derived from the fossil fuel industry and a local unemployment rate for the previous year that exceeded the national average. The Notice defines MSAs based on the 2020 census and non-MSAs based on a 2021 Bureau of Labor Statistics publication. The IRS provided a list of the areas that are considered MSAs or non-MSAs, which can be found here.

The Notice details the methodology by which the IRS will calculate historical fossil fuel employment and provides a chart of those MSAs or non-MSAs that the IRS believes have historically significant fossil fuel employment, which can be found here. Treasury and the IRS have also released a mapping tool to assist in the determination, which can be found here.

The Notice does not address the manner in which an MSA or non-MSA will determine whether it has historically significant fossil fuel tax revenues. Due to the perceived complexity around this test as a result of the multiple localities and taxing jurisdictions within most MSAs, the IRS has asked for public comment to help it formulate rules for this test.

A statistical area Energy Community requires higher than average unemployment "in the prior year." The Notice details the procedures and methodology by which this unemployment rate will be calculated. The unemployment rate is expected to be released in May of each year, and will apply to the prior year. For example, in May 2024, the unemployment rate for each MSA and non-MSA applicable to the period May 2023 through May 2024 will be released. Though this rate will change annually, once published, the information will be easily accessible to all developers and investors, which will provide needed certainty for both.

Brownfield

A project qualifies as in or placed in service in an Energy Community if it is located in a brownfield site. A brownfield site generally includes real property, the expansion, redevelopment, or reuse of which is complicated by the presence of pollution. A brownfield site also includes certain mine-scarred land. The Notice creates a safe harbor under which land can automatically qualify as a brownfield if: (i) the site was previously assessed as a brownfield site through federal, state, territory, or Indian tribal programs (e.g., a site on the Brownfields Properties list on EPA's Cleanups in My Community webpage or on similar webpages); (ii) a phase II environmental site assessment has confirmed the presence of a pollutant, contaminant, or hazardous substance; or (iii) for projects with a nameplate capacity of less than 5MW (AC), a phase I environmental site assessment has been completed. For the third category, the Notice does not specify that pollution must be found in the phase I environmental site assessment, but it is likely an implicit requirement consistent with the definition of a brownfield site.

A brownfield site does not include properties excluded from the definition of a brownfield site under CERCLA, and such excluded properties do not qualify for the safe harbor. The excluded properties include those on the National Priorities List (i.e., Superfund sites) and those subject to orders, consent decrees, or certain other requirements under CERCLA and other federal environmental statutes.

Coal Closure

A project qualifies as located in or placed in service in an Energy Community if it is located in a census tract (or adjacent census tract) where either a coal mine has closed since 1999 or a coal-fired electric-generating unit has closed since 2009. The census tracts are based on the tracts drawn following the

2020 census. The tracts will be redrawn every 10 years in accordance with the decennial census process. Census tracts are considered adjacent to one another if they touch at any single point. A mine is considered closed if, at any time since 1999, it had the status of "closed" or "abandoned" in the Department of Labor's Mine Safety and Health Administration records. A tract will be considered to have a retired coal-fired electric-generating unit if the unit has, since 2009, been classified as retired by the Energy Information Administration.

The IRS provided a table of the census tracts that it believes meet the test, which can be found here. Treasury and the IRS have also released a mapping tool to assist in the determination, which can be found here. Given the objective nature of this test, developers and investors can more easily determine whether a project will be considered located in an Energy Community under the coal closure test. When the census tracts are redrawn after 2030, a previously qualifying project may find itself outside of a coal closure census tract. Given the generous beginning of construction guidance discussed below, this is unlikely to be of practical importance.

Rules of Application

Generally, an ITC project must be "placed in service in" an Energy Community to claim increased ITCs, and a PTC project must be "located in" an Energy Community to claim increased PTCs. For an ITC project, the critical date is at or near the commercial operations date (which is at or near when placed in service occurs for tax purposes). For a PTC project, however, the Energy Community determination must be made separately for each taxable year in the project's 10-year PTC period.

If a project begins construction in a location that is an Energy Community as of the beginning of construction date, the location will be considered an Energy Community for the duration of the tax credit period in the case of a PTC project, or on the placed in service date in the case of an ITC project. This ensures that taxpayers that make an investment decision to begin a project based on its location within an Energy Community will be able to claim the anticipated tax credits for the duration of the project's tax credit period regardless of future changes to census tracts or changes in the unemployment rates in the applicable statistical area. The Notice confirms that the IRS will apply the "beginning of construction" standard, under which a taxpayer may demonstrate beginning of construction by (i) starting onsite or offsite physical work of a significant nature (the Physical Work Test) or (ii) paying or incurring 5% or more of the total cost of the project (the 5% Safe Harbor), and then completing the project within a proscribed time period or complying with a continuity requirement. A discussion of the beginning of construction requirements can be found here.

A project can ensure it is located in an Energy Community by passing the Nameplate Capacity Test, or if a project has no nameplate capacity, the Footprint Test. The Nameplate Capacity Test is passed if at least half of the nameplate capacity of the generating units is located in an Energy Community. The nameplate capacity for each generating unit is the output, in megawatts, on a steady state basis during continuous operation under normal conditions. The Footprint Test is passed if half of the square footage of a project is located within an Energy Community.

Offshore wind presented a special problem, as many projects are not located in MSA, non-MSA, or census tracts. The IRS addressed this issue by permitting an offshore wind project to qualify for bonus credits if its onshore substation is located in an Energy Community.

Key Takeaway

Although there remain some open questions, the Notice resolves many issues regarding qualification for Energy Community bonus credits and provides welcome guidance to renewable energy developers and investors in Energy Community projects.

Latham & Watkins will continue to monitor and report on developments related to clean energy tax credits.

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