Direct-Pay Options: A Review of Recent Legislative Proposals

WRITTEN BY

Anne C. Loomis | Adam C. Kobos | Roger S. Reigner, Jr. | Mitchell T. Emmert | Judy Kwok

The Biden administration earlier this year released a summary of its plans to invest in infrastructure, which included “direct-pay” options for the investment tax credit (ITC) and production tax credit (PTC) for clean energy generation and storage, as well as the Section 45Q credit for carbon capture and sequestration. The administration subsequently released the Green Book, its general explanations of the budget proposals for the fiscal year 2022, which contained more detailed information about the administration’s tax proposals but did not elaborate on the direct-pay options for the ITC, PTC, and Section 45Q credit. Congress has now passed a $3.5 trillion budget resolution, with proposed budget reconciliation legislation expected to include clean energy incentives. The applicable House and Senate committees will begin drafting the legislation later this month. In the absence of a draft budget reconciliation bill providing details on a direct-pay option, recent legislative proposals introduced in the current Congress can serve as helpful guideposts for considering how the direct-pay option will be structured.[1]

The recent proposals are consistent in many respects. All provide that the taxpayer may elect to be treated as if it has made a payment against income tax for the taxable year, thus making the taxpayer eligible for a refund of such payment if it exceeds its tax liability. The credit for which the taxpayer would otherwise be eligible is reduced, preventing a double benefit. Any payment received is excluded from gross income. Each proposal also provides that the Treasury secretary will determine the manner of making the election. However, the similarities generally end there. Below is a discussion of open questions based on the key variations between the recent proposals.

Will there be a haircut if the taxpayer elects direct pay?

The Growing Renewable Energy and Efficiency Now (GREEN) Act combines the direct-pay election with a 15% haircut of the credit. Under this proposal, taxpayers may elect to be treated as having made a payment of tax equal to 85% of the value of the ITC, PTC, or Section 45Q credit for which they are otherwise eligible, taking the reduced credit and forgoing the remainder, and requesting a refund instead of carrying forward unused credits. Other recent legislative proposals discussed here, including the Renewable Energy Investment Act, a bill solely focused on implementing a direct-pay option for ITC and PTC, do not include a haircut. The Accelerating Carbon Capture and Extending Secure Storage through 45Q (ACCESS 45Q) Act, a bill that would expand the current Section 45Q credit and add a direct-pay option, likewise includes no haircut. Bills introducing a new ITC for hydroelectricity facilities (the Maintaining and Enhancing Hydroelectricity and River Restoration Act) and a new PTC for existing merchant nuclear facilities (the Zero-Emission Nuclear Power Production Act) include direct-pay options with no haircut. While the recent trend seems to be not to require a haircut in order to elect direct pay, this trend may not be a helpful guidepost. Whether the direct-pay option in the budget reconciliation legislation will require a haircut is likely to be driven in large part by the need to balance the budget numbers due to the constraints on the reconciliation process.

When must the election be made?

Though most of the recent legislative proposals kick decisions about the time and manner of making the election to the Treasury secretary, one notable exception is the Clean Energy for America Act, the legislation co-sponsored by Senate Finance Committee Chairperson Ron Wyden, who has indicated that the Clean Energy for America Act will be the linchpin for forthcoming budget reconciliation legislation to be prepared by the Senate Finance Committee. The Clean Energy for America Act requires that the taxpayer must make the election prior to the date on which the facility is placed in service, with a transition rule applicable to facilities placed in service after December 31, 2020, and prior to enactment of the legislation. The disconnection between the timing of the election and the preparation of the tax return may force some taxpayers to choose whether to elect direct pay without the benefit of knowing taxable income or credit accrual for the full taxable year. However, this timing is a significant improvement over the discussion draft of the Clean Energy for America Act previously released by Senator Wyden, which required a taxpayer to inform the Treasury Department of its election to receive credits as direct refunds before construction on the facility to which the election relates begins.

Is the election "all or nothing"?

Most of the recent legislative proposals have included language that a taxpayer may elect direct pay for "any portion" of the applicable credit, with a corresponding reduction to the tax credit for the portion with respect to which the taxpayer made the election. This flexibility would allow a taxpayer to customize its options based on its expectations regarding taxable income, net operating losses, and credit carryforwards, and to minimize any potential haircut by electing direct pay (and accepting a haircut) only to the extent necessary. It also allows for optimization of a sponsor's potential use of tax equity. A notable departure from the "any portion" approach is the Clean Energy for America Act, under which the election is made on a facility-by-facility basis, a lack of flexibility that has the potential to become more problematic because of the bill's requirement to elect the direct-pay option at the time the facility is placed in service instead of at the time the return is prepared, as discussed above.

How is the election applied when the facility is owned by a partnership or S corporation?

The Clean Energy for America Act and the Renewable Energy Investment Act both provide that the election may be made by, and the refund paid to, a partnership or S corporation that directly holds a subject facility. The corresponding tax credit would be reduced prior to determining any partner's distributive share or any shareholder's pro rata share thereof. The Renewable Energy Investment Act requires that the entity-level election be made by the due date, with extensions, of the partnership or S corporation return for the taxable year for which the credit is determined, and further provides that an election at the partner or shareholder level applies after application of the entity-level election, thus allowing a partner or shareholder a "second bite at the apple" for direct pay. Other proposals are silent on the application of the election to partnerships or S corporations, presumably punting such questions to the Treasury secretary.

Can the direct-pay election be used even if an owner or user of the subject property is tax-exempt?

Under current law, a tax credit is not available to the extent a project is owned or used by a tax-exempt entity, government, or Indian tribal government. Many of the recent direct-pay proposals have loosened the standard by allowing the direct-pay option for property owned or used by tax-exempt entities, the United States, any state or political subdivision thereof, Indian tribal governments, any possession of the United States, and/or any agency or instrumentality of the foregoing. The Clean Energy for America Act also extends the direct-pay election to electric cooperatives and state or local utilities, which are treated as taxpayers for purposes of the direct-pay option. Notably, the GREEN Act spares electing Indian tribal governments from its otherwise applicable 85% haircut, discussed above.

---

[1] Recent proposals considered for this discussion included the Growing Renewable Energy and Efficiency Now (GREEN) Act of 2021 (H.R. 848), Accelerating Carbon Capture and Extending Secure Storage through 45Q (ACCESS 45Q) Act of 2021 (H.R. 1062), Renewable Energy Investment Act (H.R. 3180), Zero-Emission Nuclear Power Production Act of 2021 (S. 2291, H.R. 4024), Maintaining and Enhancing Hydroelectricity and River Restoration Act of 2021 (S. 2306, H.R. 4499), and the Clean Energy for America Act (S. 2118). A bill introduced in the 116th Congress, the Energy Tax Credit Direct Payment Act of 2020 (H.R. 7491) would amend the American Recovery and Reinvestment Act of 2009 to revive the Section 1603 grant program. As the bill has not been reintroduced in the current Congress, we do not discuss it here.

RELATED INDUSTRIES + PRACTICES

- Renewable Energy