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Energy Alert

AUGUST 3, 2022

Proposed Inflation Reduction Act of 2022 includes a mechanism for selling Energy Tax Credits

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This alert highlights the rules of a proposed Code section that would allow the sale of energy tax credits.

What's the Impact

- Proposed Section 6418 would allow the sale of energy credits without need of a partnership, LLC, or lease arrangement.
- The provision separates credits from depreciation which stays with the owner of the facility.
- The election to sell is made on the seller's tax return, which will be filed after the year the facility is placed in service.

The proposed Inflation Reduction Act of 2022 ("IRA-2022") has approximately 300 pages of energy provisions, the bulk of which are tax-related. In that 300 pages, there are many new Code sections, there are many extensions of existing credit provisions, there are added credits for projects that pay workers prevailing wages and establish apprenticeships, a credit specifically for storage, revival of the old 48C and adding of new 48X (both for manufacturing), a nuclear credit, and on and on. There are production credits and investment credits and homeowner and car credits. There's even $500 million committed to the IRS specially dedicated to these new provisions, presumably to enable it to hire people to write guidance.

One provision of IRA-2022 that is of particular interest is new Code section 6418. It provides a mechanism for selling energy tax credits without the need of a partnership, LLC, or lease arrangement. Of course, this is a dramatic change from the IRS's long-standing requirements to make tax benefit transfers look like traditional business deals.

This proposed new provision is the focus of this client alert.

Here's a summary of the new provisions:

- **Section 6418.** The new Code provision is in Section 6418. It's the companion to new Section 6417 that allows governments and tribes to have refundable energy tax credits. This is all in Subchapter B of Chapter 65 of the Internal Revenue Code, entitled "Abatements, Credits and Refunds." Of course, this is a long way from the sections of the Code which provide for the actual credits.
- **The Proposed New Rule Would Apply to both ITCs and PTCs.** The new provision applies to a very broad range of energy ITCs and PTCs. Interestingly, separate elections to transfer PTCs are made with regard to each facility for each year of the credit period. Compare a single LLC that owns two wind projects and allocates PTCs to a single investor to as many as 20 sales of credits under Section 6418.
- **No Government or Public Entities.** Entities eligible for the refundable credit provided by Section 6417 are not eligible for the sale of credits rule provided by Section 6418. All other taxpayers are eligible.
- **Unrelated Transferee.** Section 6418 requires that the sale of the credits be to an unrelated buyer, using the related party test of Sections 267 and 707. In general, this is the 50% test that many in the tax equity community are used to. These sections also have rules for determining whether trusts and tax-exempt entities are related.
- **Sale of less than all the credits is permitted**. The transferor can transfer less than all of its credits.
- **Multiple Transferees?** The proposed Code section refers to a transfer to "a taxpayer." While there is nothing in the section that definitively addresses whether there could be multiple transfers, it is possible that some investors may be reluctant to have multiple separate transfers absent favorable guidance from the IRS. In any case, a transferor could transfer the credits to a partnership or LLC and then allocate the credit among its partners/members.
- **Time for Making Election**. Under the proposal, an election to transfer energy credits must be made no later than the due date (including extensions) of the transferor's tax return (or 180 days after enactment, if later). This is a significant expansion of the time for transferring credits. In particular, by that time (which would be after the year in which the facility was placed in service), the parties would know that the facility had successfully begun operations.

So, there would be no need for the investor to put 20% down before placement in service, as is commonly done in accordance with applicable safe harbors.

- **Carry-forwards and Carry-backs by Transferor.** The transferor's carried-forward or carried-back credits are not eligible for the election. So, the ability to sell energy credits would only apply to newly accrued credits.
- **Paid for in Cash.** The amount paid to the transferor for the transferred energy credits must be paid in cash; at this time, we don't know whether "cash" might include deferred payments made pursuant to an installment note, although that would seem to be the right answer.
- **The Applicable Tax Year; Carry-backs by Transferee.** The buyer must claim the credits in the tax year that ends, or is the first one that includes, the seller's tax year when the credit arose. Note that Section 6418 includes an expansion of the carry-back rules, to allow the transferee to carry-back the purchased credits three years (instead of the usual one).
- **Who can sell Credits?** If a facility is owned by a pass-through entity, only the entity can sell the credits.
- **No Second Transfers.** There can only be one transfer of credits. In other words, the buyer of energy credits cannot then transfer them again. Similarly, no re-transfers are permitted by partners/members/stockholders who get allocated credits purchased by the pass-through entity of which they are a partner/member/stockholder.
- **No revocations.** Once a taxpayer has elected to transfer credits, it's stuck with the election; no revocations are permitted.
- **Tax Consequences of Sales.** Significantly, there is no taxable income to the transferor on sale of the credits, and no deduction to the transferee for the amount paid to the seller. Even though this is not structured to be a partnership transaction, this is essentially the treatment we associate with a capital contribution to a partnership, which is generally not a taxable event.
- **Separating credits from Depreciation.** The Section applies only to transfers of credits; depreciation stays with the transferor; similarly, the 50% basis reduction associated with ITCs applies to the transferor.

  Audits. If the transferee claims more credit than would otherwise be allowed under the applicable Code section (if the credit hadn't been transferred under Section 6418), it must pay the excess to the government plus 20%, unless it has reasonable cause. There's no guidance about what is meant by claiming too much credit, or what amounts to reasonable cause; presumably, if the facility has an accountant's diligence, a lawyer's tax opinion, and an appraisal, then the purchaser has "reasonable cause" for thinking it can claim the amount of credit it purchased. The Code refers to the too-large-a-claimed-credit as an "excess payment." This is undoubtedly copied from a corresponding provision in Section 6417; that section involves government "payments" which might be "excessive"; but here (in Section 6418), the term is unnecessarily confusing; it certainly isn't tied to the amount "paid" by the transferee. Given that this provision of proposed Section 6418 relates to the transferee getting a larger credit than it is properly entitled to, a better term would be "excess credit." In any case, it's not clear who bears the risk of audit. The provisions just described (providing for liability to the government if there is an excess payment) plainly refer to electing to treat the transferee "as the taxpayer," and makes the transferee responsible for any excess payments. Still, some in the tax equity community insist that the risk of a problem with the IRS stays with the transferor, presumably because it continues to be the one claiming depreciation deductions. Similarly, there doesn't seem to be any reference to recapture in these new Code provisions, whether by disposition of the property, or failure to comply with ongoing requirements that apply to the corresponding tax credit. Plainly, rule-making, and negotiations between the transferor and transferee, will be required to deal with these questions.

- **REITs.** Electing REITs are specifically mentioned in the proposed Code section, along with a modification to pre-1990 Section 46(e). The modification appears to conform the REIT rules to those described above for pass-through entities, so that the REIT, as an entity, sells the credit, rather than its investors.

All things considered, this vaguely (very vaguely) resembles the lease-pass-through (or inverted lease) structure, but without any of the complications or enhancements. The new rules separate credits from depreciation (like the lease pass-through), allowing an investor to claim only the credits, and they require an unrelated purchaser (similar to the requirement of virtually all tax advisors that the lessee in a lease pass-through be unrelated to the landlord). On the other hand, there's no "free" step-up in tax credit basis as there is with a lease pass-through and the ITC basis adjustment (if applicable) is born by the owner of the facility. Of course, most significantly, there would no longer be a need for a lease to convey the credits, a mechanism for buying out the investor, or a partnership or LLC agreement to provide a flip or buy-out mechanism. Still, as noted earlier, investors will likely still want significant diligence and confirmation of the availability of the credit. Indeed, this may lead to longer sales contracts that contain many of the representations and covenants that we now see in operating agreements or leases

Presuming Section 6418 becomes law, there's likely to be significant interest in sales of credits once the IRS issues guidance on the relevant issues. That shouldn't prevent "plain vanilla" transfers, even before there is guidance. At the same time, developers seeking to maximize their return may choose conventional deal structures, enabling them to maximize the basis upon which ITCs are computed, and/or make depreciation part of the benefits allocated to the investor.

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