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Buying U.S. Clean Energy Tax Credits? Key Considerations

The Inflation Reduction Act of 2022 (the "IRA") introduced a wide range of new and enhanced tax credits across clean energy sectors, including renewable energy, clean hydrogen, nuclear power, carbon sequestration and more. The IRA also enabled project owners to transfer clean energy tax credits to unrelated parties in exchange for cash. For project sponsors, credit transferability facilitates easier monetization of a project's available tax credits. For prospective buyers, purchasing tax credits represents an opportunity to support clean energy projects and potentially bolster the buyer's ESG credentials while acquiring credits at a discount from par.

On June 14, 2023, the Department of the Treasury and the Internal Revenue Service released further guidance on transferability under the IRA in the form of proposed regulations addressing the requirements and process of electing to transfer tax credits. The market for clean energy tax credits has become substantially more active following the released guidance. We have accordingly outlined below important considerations to keep in mind for prospective tax credit purchasers.

Background on Transferability

The IRA's provisions on tax credit transferability allow eligible taxpayers to sell all, or any portion of, their eligible credits to an unrelated party.[1] "Eligible taxpayers" are generally taxpayers that are neither tax-exempt nor governmental entities. The sale must be for cash.[2]

Once a tax credit is sold, it cannot be further transferred or resold to another party. The proposed regulations make clear that dealer arrangements, whereby a credit is transferred first from a seller to a dealer or intermediary, and ultimately transferred to a final purchaser, are not allowed. However, an arrangement under which a broker matches tax credit sellers with tax credit purchasers is allowed, assuming that at no point is the tax ownership of the credit transferred to the broker or any other intermediary.

The following types of tax credits are all "eligible credits" transferable under the IRA[3]: (1) Investment Tax Credits ("ITCs", § 48, § 48E), (2) Production Tax Credits ("PTCs", § 45, § 45Y), (3) Clean Hydrogen Production Credits (§ 45V), (4) Carbon Oxide Sequestration Credits (§ 45Q), (5) Advanced Energy Project Credits (§ 48C), (6) Advanced Manufacturing Production Credits (§ 45X), (7) Clean Fuel Production Credits

(§ 45Z), and (8) Zero-emission Nuclear Power Production Credits (§ 45U).[4] The ITC and the PTC are the most commonly utilized credits at the moment, but others are expected to see greater utilization as the market for the relevant technologies develops further.

The ITCs are a one-time dollar-for-dollar tax credit for expenses invested in renewable energy properties. Project developers can receive an ITC in the amount of between six and 50% of such expenses, depending on the location of the project and whether the project qualifies for certain bonus credits linked to prevailing wage and apprenticeship and domestic content requirements.[5] The ITC can be claimed for the year that the project was placed in service (which is essentially when it has been completed and starts operations).

The PTCs are a dollar-for-dollar tax credit based on the kilowatt-hours of clean energy produced. Project developers can receive a credit of between 0.3 and 1.8 cents per kilowatt hour (again depending on the location of the project and whether the project qualifies for certain bonus credits linked to prevailing wage and apprenticeship and domestic content requirements), usually for the 10-year period after the clean energy facility is placed in service.[6]

A seller of eligible tax credits may not transfer any carryback or carryforward tax credits.[7] However, a purchaser of eligible tax credits may carry back or carry forward the purchased credits, which are generally allowed a three-year carryback period (as opposed to the usual one-year carryback) and a 22-year carryforward period (as opposed to the usual 20-year carryforward).[8]

To transfer the credit, a seller is required to register with the IRS through an electronic portal prior to making the transfer election and receive a valid registration number for each of the credit properties.[9] Then, the seller must file certain forms as part of filing its original tax return for the taxable year for which the credit is determined, not later than its due date (including extensions).[10] In order to claim the purchased credit, the purchaser must also include certain forms with its tax return (original or amended).[11]

Key Considerations for Transferability

Below are key considerations that any prospective purchaser of tax credits should bear in mind:

- **Price:** Tax credits are generally sold at a discount, but the price can vary by the nature of the credit and of the underlying projects (for example, a one-time purchase for an ITC vs. multiple purchases available for a PTC), how far in advance the credit is purchased, the creditworthiness of the seller, the strength of seller indemnity or insurance and other factors.
- **Risk of Penalties and Recapture:** Generally, tax credits are allowable only to the extent that certain specified external criteria are met. For example, if an ITC project ceases to be eligible for the ITC or a bonus adder of the ITC or if the project no longer uses an asset for which it received the ITC, the purchaser, rather than the seller, remains liable for any recapture of the ITC, even though the purchaser may not be in a position to directly mitigate such risk themselves.

  When the tax credit is subject to recapture and it is determined that there has been an “excessive” transfer, not only does the purchaser have to return the excess tax credits claimed, but the purchaser is also subject to a 20% penalty on such excess.[12] In order to mitigate recapture risk and avoiding penalties, purchasers should consider:

  - Contracting with the seller for indemnification in the event of recapture;

    - Obtaining insurance to cover recapture risk, which may be conditioned on certain threshold requirements being met, and may be underwritten based on supporting documentation provided by a project developer; and
    - Doing sufficient diligence to ensure, among other considerations, that the seller is eligible for the tax credit and eligible to transfer the tax credit, the tax credit is eligible to be transferred, and the seller has followed all required procedures for making a valid transfer election.

- **Anti-Abuse Measures:** Proposed regulations would prohibit, or recharacterize, tax credit transfers (and associated transactions) primarily intended to avoid tax liability beyond the limits intended by the IRA.[13] For example, a seller would not be able to artificially decrease its taxable income by undercharging a customer for services, where that customer is making up for the difference by purchasing clean energy tax credits from the seller.
- **Individual Buyers:** It will be very difficult for most individuals to utilize the purchased tax credits efficiently under the proposed guidance, since they will only be able to use the purchased tax credits to offset taxes on income from the project that generated those tax credits under the "passive activity loss" rules (which generally allow an individual to use the tax credit from a trade or business activity only if they materially participate in that activity).[14]

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ENDNOTES

[1] Section 6418(a). All citations to "Sections" are to sections of the Internal Revenue Code.

[2] Section 6418(b)(1); Prop. Reg. Sections 1.6418-2(a)(4)(ii); 1.6418-2(e)(1); 1.6418-1(f)(1).

[3] All citations are to the Internal Revenue Code.

[4] Section 6418(f)(1)(A); Prop. Reg. Section 1.6418-1(c).

[5] Section 48(a)(9). First, all wages paid to any laborers or mechanics employed by the taxpayer claiming the credit or any contractor or subcontractor must be paid at rates no less than the "applicable prevailing rates" in the locality where the project is located. Second, a certain percentage of construction labor hours for the project must be performed by qualified apprentices. Section 48(a)(10), (11).

[6] Section 45(b)(7), (8). Both ITCs and PTCs can be further increased by up to 10% each if: (1) the energy facility meets certain domestic content requirements, which generally require that any steel, iron or manufacturing product that is a component of the project be produced in the United States, and (2) the energy facility is located in a fossil-fuel-dependent "energy community," which includes brownfield sites, census tracts where a coal mine has closed or where a coal-fired electric generating unit has been retired, and areas with both (i) specified minimum percentages of direct employment or local tax revenues related to the extraction, processing, transport, or storage of coal, oil, or natural gas, and (ii) an unemployment rate at or above the national average for the previous years. Sections 48(a)(12), (14); 45(b)(9), (11).

[7] Section 6418(f)(1)(C).

[8] Section 39(a)(4); Prop. Reg. Section 1.6418-5(g).

[9] Prop. Reg. Section 1.6418-4(a).

[10] Prop. Reg. Section 1.6418-2(b)(3), (4). These forms include: (1) a properly completed relevant source credit form for the eligible credit (such as Form 7202, *Advanced Manufacturing Production Credit*, if making a transfer election for the Section 45X credit); (2) a properly completed Form 3800, *General Business Credit*, including the registration number received during the pre-filing registration; (3) a schedule attached to the Form 3800 showing the amount of eligible credit transferred for each credit property; (4) a transfer election statement; and (5) any other information specified in any further guidance issued in the future.

[11] Prop. Reg. Section 1.6418-2(f)(4). These forms include: (1) a properly completed form 3800, *General Business Credit*, and all registration numbers related to the transferred credit; (2) the transfer election statement; and (3) any other information related to the transfer election specified in guidance.

[12] Prop. Reg. Section 1.6418-5(a). Purchasers can avoid the 20% penalty on excessive credit transfers by demonstrating "reasonable cause" for the excessive credit transfer. Under proposed regulations, purchasers may be able to demonstrate "reasonable cause" through factors such as review of the seller's documentation for credit eligibility, reasonable reliance on third party expert reports, and review of public company audited financial statements, if applicable. With respect to mitigating recapture risk (*and* avoiding penalties), purchasers should consider either contracting with the seller for indemnification in the event of recapture, or obtaining insurance to cover recapture risk. *Id.*

[13] Prop. Reg. Section 1.6418-2(e)(4).

[14] Section 469.

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