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Insights

THE TRANSFERABILITY OF TAX CREDITS

THE CREATION OF SECONDARY MARKET UNDER THE INFLATION REDUCTION ACT

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OVERVIEW

The Inflation Reduction Act of 2022 (the "IRA") represents the largest investment in clean energy and climate change in the history of the United States, with over $370 billion of funding to provide tax credits for clean energy projects. The IRA provides taxpayers with options to monetize these credits, one of which is the ability to transfer credits to third party purchasers.

Historically, credits could not be sold to third parties (with a few exceptions) and an industry developed around certain tax equity structures designed to provide developers an additional avenue to raise capital by disproportionately allocating credits to parties that could use them in exchange for capital contributions. Such structures not only allocated the credits, but depreciation and losses as well, all under general partnership tax rules. Tax equity structures are complex and are burdened by significant legal, tax, accounting and consulting costs.

The mechanism for the transfer of credits under the IRA is understood to be a supplement, not a replacement, for tax equity financing, and was enacted in order to attract capital that tax equity deals were not already attracting. The IRA's new transfer provisions under Section 6418 of the Internal Revenue Code (the "Code") set forth a novel credit delivery mechanism, which essentially separates the credits from the project. This allows developers an option to retain full ownership of the project (as opposed to tax equity deals). Commentators have noted that credits eligible for transferability will likely attract significant investment from large, profitable corporations.

While the credits can be transferred, as outlined below, the IRA's transferability provisions have certain inherent shortcomings. First, credits are expected to trade at a discount, such that the full value of the credits will not be realized by the transferor. With respect to the transferee, this discount should not be income (the Joint Committee on Taxation has indicated that it would not be appropriate to impose a gain on such discount). Second, there is no deduction for the payment by the transferee (in a tax equity deal, investment is effectively deductible to a certain extent due to depreciation). And, third, transferability does not apply to depreciation. Given many project developers do not have the capacity to benefit from depreciation deductions, it is unclear whether

taxpayers will utilize hybrid models of credit transfers and smaller tax equity transactions going forward under the IRA.

The Internal Revenue Service (the "Service") has publicly stated that guidance in this area is forthcoming, but has not been released as of the date of this alert.

SECTION 6418 OF THE CODE – IN GENERAL

Section 6418 of the Code permits an eligible taxpayer to elect to transfer all or a portion of an eligible credit determined with respect to such taxpayer for any taxable year to an unrelated taxpayer.

An eligible taxpayer is any taxpayer other than a tax-exempt organization, a State or political subdivision thereof, the Tennessee Valley Authority, an Indian tribal government, an Alaska Native Corporation, or a corporation operating on a cooperative basis which is engaged in furnishing electric energy to persons in rural areas. Tax exempt, other governmental entities and entities described above may benefit from the direct-pay provisions of the IRA, which are not the subject of this alert.

Eligible credits to transfer generally include the following:

- Sections 45, 45Y Clean electricity production tax credit
- Sections 48, 48E Clean electricity investment tax credit
- Section 45U Zero-emission nuclear power production credit
- Section 45Q Credit for carbon oxide sequestration
- Section 45Z Clean fuel production credit
- Section 45V Clean hydrogen production tax credit
- Section 30C Alternative fuel vehicle refueling property credit
- Section 48C Advanced energy project credit
- Section 45X Advanced manufacturing production credit

Taxpayers may only transfer credits to which they are entitled, after the application of any limitations (such as the limitation on projects financed by tax-exempt bonds). Under the IRA, credits are subject to a three-year carryback and a twenty-two year carryforward.

TRANSFER MECHANICS

The consideration for a transfer of credits must be paid in cash. It is understood that the Service is working on guidance to include advance payments prior to a credit transfer and deferred payments after a credit transfer to be included in the cash consideration via a safe harbor provision. The cash consideration is not includible in the gross income of the transferring taxpayer nor is it deductible by the transferee taxpayer. The transferee taxpayer may not transfer the credits received pursuant to Section 6418 (there is no ability to make a second transfer). The transferee taxpayer is treated as the taxpayer for purposes of the Code regarding the credit or portion of the credit purchased. As such, it will be crucial for the transferee and transferor to agree upon certain tax cooperation provisions, including, but not limited to, audit procedures with respect to the credits and to credit recapture issues (for investment tax credits) in the accompanying transfer agreements.

In the case of any project held directly by a partnership or S corporation, a credit transfer election must be made at the partnership or S corporation level. If a partnership or S corporation makes an election to transfer credits under Section 6418, any amount received as consideration is treated as tax-exempt income and a partner's distributive share of such tax-exempt income is based on such partner's distributive share of the otherwise eligible credit for each taxable year. It is understood that the Service is working on guidance to address the application of the at-risk and passive activity rules to Section 6418 transfers.

An election to transfer any portion of an eligible credit must be made not later than the due date (including extensions of time) for the tax return for the taxable year for which the credit is determined. Any such election, once made, is irrevocable and no additional election may be made by a transferee taxpayer with respect to any credits received under the provision.

As stated above, guidance on the transferability provisions is expected imminently.

MEET THE TEAM

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