ALERTS

Renewable Energy Tax Credit Transfer Guidance Provides Both Clarity And Pitfalls

June 30, 2023

Highlights

- The renewable tax credit transfer market will accelerate with new government guidance; public hearing and comments deadlines are scheduled for August
- Risk allocation puts the usual premium on sponsors with a balance sheet and/or recapture insurance coverage
- While the guidelines provide clear rules and examples, many foot faults are present

On June 14, 2023, the Treasury Department and Internal Revenue Service issued long-awaited guidance on the transferability of certain renewable energy-related federal tax credits. The guidance takes the form of a notice of proposed rulemaking, proposed regulations, and an online Q&A, with a public hearing to follow in August.

Under new Code Section 6418, eligible taxpayers can elect to transfer all or any specified portion of eligible tax credits to one or more unrelated buyers for cash consideration. While the tax credits can be sold to more than one buyer, subsequent transfers by the buyer are prohibited.

This alert highlights several practical issues raised by the guidance, which

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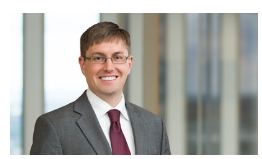

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should allow participants waiting for more clarity to proceed.

Individual Buyers Left Out

- The guidance applies the Code Section 49 at risk rules and Section 50(b) tax-exempt use rules, generally restricting sellers in calculating the amount of tax credits for sale, and Code Section 469 passive activity rules, generally restricting buyer's use of such tax credits, in various contexts. On the buyer side, these rules appear to be more restrictive than the limitations that would apply to identical tax credits in an allocation, rather than sale, context. Suffice to say, this will prohibit individuals from taking part in the transfer market for practical purposes outside of fact patterns of very limited application.

  While this result may not be surprising since such rules currently severely restrict individuals from participating in traditional federal tax credit equity structures, there was some hope for a different outcome due to the stated policy goal of increasing renewable energy investment (not to mention the Inflation Reduction Act's general departure from decades of case law precedent and IRS enforcement action prohibiting sales of federal tax credits with the enactment of Section 6418).

Lessees Cannot Sell the Tax Credits

- A lessee cannot transfer the credit. With the prevalence of the master lease (inverted lease) structure in tax equity transactions, this prohibition created an unexpected roadblock for deal participants who have been structuring tax equity transactions with backstop type sale provisions for almost a year now. This presents developers, at least in the inverted lease context, with a choice of utilizing a traditional tax equity structure for the purpose of obtaining a tax-free step up in basis to fair market value, or forgoing the step up for less financing but also less structure complexity. The standard partnership flip project sale into a tax equity type of holding company structure could still remain a viable alternative.

  As the transfer is generally made on a property-by-property basis by election, creative structuring, in theory, could allow for a lessor to retain certain property and sell the related tax credits (e.g., on portfolios with more than one solar installation/project, or even with large projects that go online on a block-by-block basis assuming the "energy project" election is not made – a term that future guidance will need to provide more clarity on).

  However, this seems to be an ivory tower conclusion currently, and the practical reality is that too many unknown issues could be raised by such out of the box structuring, including the fact that conservative institutional investors may refuse to participate in such a structure until clear objective guidance is published addressing the same.

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Bonus Credits Cannot Be Sold Separately

- Bonus credits cannot be sold separately from the underlying base credit. This is more problematic for certain adders – for example, the energy community adder rules are now out and amount to simply checking a location on a website. Others (e.g., the low-income community or domestic content adder) require more extensive and subjective application and qualification procedures which makes when and how such adders can be transferred difficult to ascertain. Projects hoping to transfer such credits may need to be creative in compensating buyers for such uncertainty and qualification risk. Tax equity transactions that closed prior to the guidance's issuance may also need to be revisited, as provisions in such transaction documents commonly attempted to bifurcate the bonus credit away from the base credit in order to allow the sponsor to separately sell such adders.

Buyers Bear Recapture Risk and Due Diligence Emphasis

- While the Joint Committee on Taxation Bluebook indicated the buyer is responsible for recapture, industry participants were still hoping such risk would remain with the seller. Outside of the limited situation of indirect partnership dispositions (which still results in a recapture event to the transferring partner if triggered), the recapture risk is borne by the buyer, using the rationale that the buyer is the "taxpayer" for purposes of the transferred tax credits. While this is familiar territory for tax equity investors, whose allocated tax credits would be reduced in a recapture scenario, tax credit purchase transactions are now burdened with what amounts to the standard tax equity type of due diligence, including negotiation of transaction documents outside of a basic purchase agreement.

- The guidance provides that indemnity protections between the seller and buyer are permitted. Tax equity transactions historically have had robust indemnification provisions, which should remain the case even more so in purchase/sale transactions. Tax equity investors traditionally bear "structure risk" dealing with whether the investor is a partner for tax purposes – such risk is eliminated in the purchase scenario as the purchasing investor no longer needs to be a partner (subject to the caveat of a buyer partnership discussed below).

- If the buyer claims a larger credit amount than the seller could have, such "excessive credit transfer" will subject the buyer to a 20 percent penalty on the excess amount (in addition to the regular tax owed). All buyers are aggregated and treated as one for this purpose – if the seller retains any tax credits, the disallowance is first applied to the seller's retained tax credits. A facts and circumstances reasonable cause exception to avoid this penalty is provided, further emphasizing the need for robust due diligence.

  Specific non-exclusive examples that may demonstrate reasonable cause include reviewing the seller's records with respect to determining the tax credit amount, and reasonable reliance on third-party expert reports and representations from the seller. While not unique to this new tax credit transfer regime, the subjective and circular nature of such a standard is complex – for example, when is it not "reasonable" for buyers or other professionals to rely on other board certified and licensed professionals, such as an appraiser or independent engineer with specialized knowledge?

- Buyers thus need to remain vigilant about potential recapture causing events. For example, tax equity investors will not generally allow project level debt on investment tax credit transactions without some sort of lender forbearance agreement that provides that the lender will not cause a tax credit recapture event (such as foreclosing and taking direct ownership of the project). Buyers remain responsible for such a direct project level recapture event, which again aligns the tax credit transfer regime with tax equity due diligence and third-party negotiation requirements. The guidance is more lenient for the common back-leverage debt scenario.

  While similar interparty agreements between back leverage lenders and the tax equity investor are required for non-project level debt facilities to address tax credit recapture among other issues, the guidance provides that a partner disposing of its indirect interest in the project (e.g., the lender foreclosing and taking ownership of a partner's partnership interest) will remain subject to the recapture liability rather than the buyer provided that other tax-exempt use rules are not otherwise implicated. However, the need to negotiate such lender related agreements is still implicated as not all recapture risk in even this scenario was eliminated to the buyer.

- While the recapture risk could place a premium on production tax credit deals (that are technically not subject to recapture or subjective basis risk), the burdensome process of needing to buy such tax credits on a yearly basis in line with sales of output may make such transactions more tedious.

- The insurance industry already has products in place to alleviate buyer concerns, but this is just another transaction cost in what may be a tight pricing market. Not unlike tax equity transactions, sponsor sellers with a balance sheet to backstop indemnities may be able to demand a pricing premium; other sponsors may need to compensate buyers with lower credit pricing to reward such risk and or/to allow the purchase of recapture insurance. While this seems logical, the guidance also includes anti-abuse type rules whereby low credit pricing could be questioned in terms of whether some sort of impermissible transfer by way of other than cash occurred (e.g., a barter for some sort of other service). What the IRS subjectively views as "below market" pricing could trigger some sort of audit review based on this factor alone which further stresses the importance of appropriate due diligence.

Partnerships and Syndications

- The guidance provides very clear rules with helpful examples, which should allow partnership sellers and buyers to proceed with very objective parameters. For example, the rules allow a partnership seller to specify which partner's otherwise allocable share of tax credits is being sold and how to then allocate the tax-exempt income generated. The cash generated from sales can be used or distributed however the partnership chooses.

- Similar objective rules and examples are provided for a buyer partnership. Subsequent direct and indirect allocations of a purchased tax credit do not violate the one-time transfer prohibition. Purchased tax credits are treated as "extraordinary items" that must be allocated among the partners of the buyer partnership as of the time of the transfer, which is generally deemed to occur on the first date a cash payment is made. Thus, all partners need to be in the partnership on such date to avoid an issue. Purchased tax credits are then allocated to the partners in accordance with their share of the nondeductible expenditures used to fund the purchase price.

- What level of end-user comfort is needed in such a syndicated buyer partnership is an open question. While the rules provide objective guidelines in terms of when and how such purchased credits are allocated, subjective questions that are present in (and focused on) traditional tax equity partnerships are implicated. For example, could a syndication partnership set up for the business purpose of what amounts to selling the tax credits somehow run afoul of the subjective business purpose and disguised sale rules in tax credit case precedent, such as the Virginia Historic Tax Credit Fund state tax credit line of precedent? Will the market require a robust tax opinion in such scenario, thereby driving up transaction costs?

  An example in the proposed regulations speaks to this sort of partnership formed for the specific purpose of buying tax credits, but leaves out of the fact pattern a syndicator partner. The example itself should go a long way towards blessing such arrangements, but the IRS taking a contrary position when dealing with such issues would not be a new situation. For example, the IRS challenged allocations of federal historic tax credits as prohibited sales of federal tax credits to the point of freezing the entire tax equity market with its positions in Historic Boardwalk Hall, which was only rectified with the release of a subsequent safe harbor revenue procedure.

- Moreover, the guidance provides that tax credit brokers are allowed to participate in the market so long as the tax credits are not transferred to such brokers as an initial first step in the transfer process (as the subsequent transfer to an end user would violate the one-time transfer rule). Specifically, at no point can the federal “income tax ownership” be transferred to a broker. It is an open question if further distinction will be made at where this ownership line should be drawn. For example, can a third party enter into a purchase agreement with a seller and then transfer such rights prior to the transfer election being made? Does it matter under such analysis if 1) purchase price installments have been paid (which implicates rules in the buyer partnership context as noted above) and/or 2) the tax credit generating eligible property has been placed in service (which is when the investment tax credit vests for an allocated tax credit analysis; a production tax credit generally arises as electricity or the applicable source is sold)?

- Indirectly implicated is what effect the new transfer rules will have on established case law precedent and IRS enforcement action in traditional tax equity structures. The Inflation Reduction Act and guidance dances around certain of these issues by creating a fiction where the buyer is treated as the “taxpayer” – this avoids the issue of turning a federal tax credit into “property” that can be sold similar to a certificated state tax credit. This also provides a more logical explanation as to why the buyer of these federal tax credits does not need to report any price discount as income when utilized, unlike the well-established federal tax treatment of certificated state tax credits that provides the exact opposite (e.g., a buyer of a certificated state tax credit at $0.90 has to report $0.10 of income on use of such tax credit).

Other Administrative and Foot-Fault Issues

- The purchase price can only be paid in cash during the period commencing with the beginning of the seller’s tax year during which the applicable tax credit is generated and ending on the due date for filing the seller’s tax return with extensions. Thus, such period could be as long as 21.5 months or more (e.g., a calendar year partnership seller extending its return to Sept. 15). Tax equity transactions generally have pricing timing adjusters for failure to meet placement in service deadlines. Such mechanism will not work if advanced payments were made and then the project’s projected placement in service year changes. Tax credit purchase agreements executed prior to the June 14 guidance may require amendments or complete unwinds to line up with the rules to avoid foot faults (e.g., purchase agreements executed in 2022 where a portion of the purchase price was paid in 2022 for anticipated 2023 tax credits would not fall within the “paid in cash” safe harbor period). Advanced commitments, so long as cash is not transferred outside of the period outlined above, are permitted.

- The typical solar equity contribution schedule of 20 percent at a project’s mechanical completion makes purchase price schedules approximating the same a reasonable adjustment for most investment tax credit energy deals in terms of the timing of financing. In addition, the advance commitment blessing of the guidance will give lender parties the comfort necessary similar to having executed tax equity documents in place. Thus, typical project construction financing mechanisms should be similar in the tax equity versus purchase agreement scenario, with projects that allow for a more delayed funding mechanism possibly obtaining a tax credit pricing premium. Production tax credit deals, for which tax credits can only be paid for on a yearly basis within the cash paid safe harbor timing window, may have more significant project financing hurdles without further tax credit transfer rule modifications.

- Sellers can only make the transfer election on an original return, which includes extensions. Buyers, by contrast, may claim the purchased tax credit on an amended return.

- Buyers need to be aware that usage of the purchased tax credits is tied to the tax year of the seller. For example, a fiscal year seller could cause the tax credits to be available a year later than an uninformed buyer anticipated, regardless of when the tax credit was generated using a traditional placement in service analysis. For example, a solar project placed in service during November 2023 by an August fiscal year seller would generate credits first able to be used in a calendar year buyer's 2024, instead of 2023, tax year. A buyer can use the tax credits it intends to purchase against its estimated tax liability.

- The pre-registration requirements, which are expansive and open-ended, are also tied to the taxable year the tax credits are generated and generally must be made on a property-by-property basis. For example, 50 rooftop installations could require 50 separate registration numbers outside of the "energy project" election. When such registration information needs updated is also not entirely clear – for example, a project is often sold into a tax equity partnership syndication structure on or before mechanical completion. Needing to update registration information could delay transactions and implicates unknown audit risk.

While these rules provide much-needed clarity, failure to adhere may be catastrophic and will require sellers and buyers to put proper administrative procedures in place to avoid foot faults. The new transfer regime will expand the market to new buyers who may have viewed tax equity as either too complex or had other reasons to avoid these transactions, such as the accounting treatment of energy tax credit structures. However, it would be prudent for such buyers to approach such transactions with eyes wide open.

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