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Transferability: Selling tax credits

By Keith Martin in Washington, DC

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The US Treasury is expected to issue guidance about direct sales of federal tax credits by the second quarter this year.

Sales are moving forward without waiting for the guidance.

Production and investment tax credits on solar and wind projects are trading for the most part at prices of between 90¢ and 92¢ per dollar of tax credit. A significant number of transactions are in the term sheet stage. Some have moved into documentation.

Prices should increase over time as more buyers come into the market, particularly as deadlines approach to file tax returns since companies that are potential buyers should have more insight into their tax liabilities closer to filing deadlines.

It takes time for new markets to develop. For example, it took four years after Congress fixed problems in early 2018 that were preventing a tax equity market from developing in section 45Q tax credits for capturing carbon emissions before the first tax equity transaction closed in early 2023.

Many people expect prices eventually to settle at 95¢ or 96¢, although some brokers expect them to reach as high as 98¢ and others expect a much wider range. Some recent offers in the 80¢ range have been rejected by sponsors.

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The Inflation Reduction Act authorizes owners of new clean energy infrastructure to sell nine types of federal tax credits to other companies for cash. The tax credits must have arisen in 2023 or later to be sold. The rules for such sales can be found in section 6418 of the US tax code.

Many early buyers are existing tax equity investors and utilities that feel they understand the businesses to which the tax credits relate.

The deadline to sell tax credits is at least until year end for the year the seller becomes entitled to a tax credit and probably the due date for filing the tax return for the year. Thus, for example, 2023 tax credits could be sold up until the seller files its 2023 tax return in 2024. The buyer claims the tax credits in its tax year that ends on the same date as the seller's tax year (or that straddles the back end of the seller's tax year for buyers with different tax years). The buyer can carry them forward if not used immediately.

The seller must notify the Internal Revenue Service of the sale by filing an "election" with its tax return.

Sellers do not have to report the sales proceeds as income. The buyer cannot deduct its purchase price. Buyers pay less than 100¢ per dollar of tax credit because they need to profit from the transaction.

Tax equity v. sale

It is now standard practice in partnership-flip tax equity deals for the tax equity investor to insist on the right to direct the partnership to sell the tax credits. All tax equity transactions involving production tax credits, and 80% of tax equity financings involving investment tax credits, are structured as partnership flips. (For more details on structures, see "Solar Tax Equity Structures" in the December 2021 *NewsWire* and "Partnership Flips: Structures and Issues" in the February 2021 *NewsWire*.)

Many people wonder why a project developer would incur transaction costs to put a tax equity financing in place and then incur still more such costs to have the tax equity partnership sell the tax credits.

The tax equity investor demanding the right to force a sale sometimes pays the sale costs.

Combining both approaches allows the developer to "step up" the tax basis on which investment tax credits and accelerated depreciation are calculated by selling the project company to the tax equity partnership near the end of construction for the appraised value the project is expected to have when fully built. When the tax credits are later sold, they are calculated on the fair market value rather than the bare cost to construct.

Raising tax equity also allows the developer to get value for the tax depreciation on a project. Most renewable energy projects are depreciated on a front-loaded basis over five years. The tax credits are worth at least 30¢ per dollar of capital cost and could reach as high as 70¢ on some projects. The depreciation is worth another 14¢. (For more details, see "Bonus Tax Credits and the Inflation Reduction Act" in the October 2022 *NewsWire*.)

A tax equity market is not expected to develop in depreciation-only projects. The economics of such transactions are not sizable enough.

Tax credits on a project that is owned by a partnership can only be sold by the partnership. They cannot be allocated to partners who decide individually whether to sell.

Tax equity investors want the ability to direct the partnership to sell because it is a way to syndicate the tax equity by bringing in another investor later. Until now, any tax equity investor planning to share in the investment tax credit on a new renewable energy project had to be a partner in the partnership that owns the project before it is placed in service. This meant tight deadlines for developers to put tax equity in place. The ability to sell tax credits allows more time not only for investors to syndicate their positions, but also for developers who decide to forego tax equity to transact.

A later sale of tax credits by the partnership may also be an answer for how to treat tax credits on later improvements to a project, or allow later phases of a single project to be financed in a single tax equity vehicle, beyond the period the tax equity investor feels it can commit to have enough tax capacity.

Sales are also a way for some tax equity investors who lack current tax capacity to remain active in the market.

The market is still feeling its way on all of the potential uses of the direct-sale option.

Another reason to try to move a project into a tax equity vehicle is tax equity provides upfront funding for projects on which production tax credits will be claimed over 10 years on the electricity output. PTC sales are likely to draw annual or quarterly payments as tax credits are earned. Some banks are exploring lending bridge debt against the future payment streams in cases where there have been forward sales of all 10 years of tax credits. However, early offers from lenders have been at advance rates as low as 50% of the future payment streams.

Complications

Sales of tax credits by tax equity partnerships raise four issues.

If the partnership allocates the tax credits to partners, the tax credits are credited at 100¢ on the dollar against the target yield the investor must reach before its partnership interest flips down to 5%. What should happen when a partnership sells tax credits at a discount to credit value and distributes the discounted cash? Most tax equity investors to date have been willing to credit the full tax credit value as if the credits had been allocated in exchange for control over the terms of the tax credit sale.

The partnership will have to indemnify the tax credit buyer if the tax credits are recaptured or disallowed by the IRS. The parties negotiate a careful risk allocation in the partnership agreement. That risk allocation needs to be preserved so that the partner whose risk led to the loss must contribute capital to cover the indemnity payment.

The developer will want control over any contest with the IRS over disallowed tax credits in cases where it will have to fund the indemnity. To that extent, the developer may not be able to cede all say over the terms of the tax credit sale to the investor.

In partnership flip transactions where the right for the investor to direct a tax credit sale is added after the parties are already far along in negotiations, the deal papers have to be reworked to distribute the sales proceeds 99% to the tax equity investor. In most flip deals, 99% of income, loss and tax credits are allocated to the investor, but cash is distributed largely to the developer.

A partnership selling tax credits reports the sales proceeds as tax-exempt income. This income pushes up the partners' capital accounts and outside bases, two metrics for tracking what each partner put into the partnership and is allowed to take out. The tax-exempt income must be allocated to partners in the same ratio the tax credits would have been allocated: thus, 99% to the tax equity investor. The allocation to the tax equity investor provides room for it to be distributed 99% of the cash sales proceeds but complicates any deal where the parties want to distribute the sales proceeds to the developer.

Nine Tax Credits

Nine types of tax credits can be sold. They are tax credits under the following US tax code sections: 45, 45Y, 48, 48E, 45Q, 45V, 45U, 45Z 45X, 48C and 30C. (Although there are 11 sections listed, there are only nine tax credits as two of them move after 2024 to new tax code sections.)

The nine credits are production tax credits for generating renewable or nuclear electricity, capturing carbon emissions or producing clean hydrogen and clean transportation fuels (like sustainable aviation fuel), tax credits for manufacturing wind, solar and storage components or processing, refining or recycling 50 types of critical minerals, tax credits for building new factories and re-equipping existing assembly lines to make or recycle products for the green economy and reduce greenhouse gas emissions at existing factories by at least 20%, and tax credits for installing electric vehicle and other clean fuel charging stations in low-income and rural areas.

Tax credits can only be sold once. Thus, a buyer cannot resell the tax credits it purchases. The buyer must pay cash.

Tax credits that are carried into a year from another year cannot be sold.

Developers building projects, like offshore wind farms, that have normal construction periods of at least two years, can claim investment tax credits on progress payments made to the construction contractor during construction rather than waiting, as in the normal case, until the project is placed in service to claim the full tax credit. These so-called QPE tax credits — QPE stands for qualified progress expenditures — cannot be sold. The Treasury will have to decide whether the full tax credit can be sold in the in-service year even though it was claimed earlier by the project owner.

The tax credit buyer cannot be related to the seller.

It is related if it has more than 50% overlapping ownership. A partner is related to a partnership if it has more than a 50% profits or capital interest in the partnership. Partnerships are already careful not to sell the electricity to such partners because such a sale will prevent the partnership from claiming net tax losses during the first few years from accelerated depreciation. (For more details on affiliate sale issues, see "Another Utility Tax Equity Structure" in the February 2022 *NewsWire* and "Section 707(b): Related-Party Electricity Sales" in the June 2021 *NewsWire*.)

A seller can transfer all of part of the tax credits. For example, the sale can be for a set dollar amount of tax credits. It can be for a percentage of the tax credits. Some tax equity investors want the ability to direct a partnership to sell only the tax credits that would otherwise be allocated to them. Whether that is permitted will have to wait for Treasury guidance.

Congress was concerned about inflated tax bases used to calculate tax credits. The Inflation Reduction Act authorizes the IRS to collect a penalty of 120% of any excessive tax credit claimed where part of the tax credit is later disallowed for any reason, and not just an inflated tax basis. Tax credit sale agreements should require the buyer to indemnify the seller in the event such a penalty is imposed that the IRS collects from the seller to the extent the buyer claims more tax credits than it paid the seller to purchase.

The option to sell tax credits was supposed to democratize tax equity. It is hard for developers below the top tier to raise tax equity.

Smaller sellers will have a hard time selling tax credits because buyers will expect creditworthy indemnities in the event the tax credits are later recaptured or disallowed.

Thus, smaller sellers may end up having to buy insurance to backstop indemnities. Tax insurance policies have generally required payment of a one-time premium of 2% to 3% of the maximum potential payout. The indemnity backstop insurance is too new for brokers to have established what is "market."

Some project developers have business metrics that put a premium on cash. Examples are yield cos. This may make them candidates for tax credit sales.

Open Issues

The market is looking to Treasury for guidance about a number of issues, but in many cases, the tax bar has already formed a view and the lack of guidance should not stop transactions from moving forward.

The market assumes that most individuals, S corporations and closely-held C corporations are not suitable buyers. A closely-held C corporation is a corporation in which five or fewer individuals own more than half the stock. The market assumes that passive-loss and at-risk rules will apply to such buyers making it hard for most of them to use any tax credits they purchase. (For more details on the passive loss restrictions, see "Challenges Facing Individuals as Tax Equity Investors" in the June 2022 *NewsWire*.)

Partnerships with "unblocked" pension funds, foundations, Indian tribes or other tax-exempt or government entities as direct or indirect investors lose the ability to claim a percentage of the investment tax credit and accelerated depreciation on their projects. The percentage is the high-water mark of the tax-exempt and government ownership. Thus, for example, if such investors start with a 1% interest, but this is expected to flip later to 95%, 95% of the ITC and accelerated depreciation are lost.

However, the Inflation Reduction Act allows such entities that own projects directly to apply to the IRS for cash payments for 100¢ per dollar of tax credit. Companies have been asking whether a partnership between a private developer and such investors qualifies for a cash payment for the share of tax credits that belongs indirectly to the tax-exempt or government entity. The market assumes the answer is no. The partners would have to own the project as "tenants in common," meaning each has an undivided interest in the project, rather than as a partnership, in order for this to work.

The market is waiting for the Treasury to say whether tax credits that company A transfers to company B under another tax code section or IRS regulation can be sold by B. An example is where tax credits are transferred to a tax equity investor by leasing the project to the investor and electing under IRS regulations to let the investor claim the investment tax credit. Another example is where section 45Q tax credits are transferred by the owner of the carbon capture equipment by electing under section 45Q to allow the company that will dispose of the captured carbon emissions to claim the tax credits.

Another significant issue is whether the tax credit buyer must report income equal to its profit when it uses the tax credit to extinguish a tax liability.

For example, must a buyer who pays 90¢ per dollar of tax credit pay 10¢ as taxable income when the tax credit is used. The IRS said in an internal legal memorandum in 2007, and repeated in a private letter ruling in 2009, that buyers of state tax credits must report such a profit. The IRS said state tax credits are "property" and when they are used to pay a tax bill, the taxpayer should be treated as if it converted the tax credit into cash equal to the full amount of the tax credit and used the cash to pay its tax bill. The conversion triggers a taxable gain. (For more details, see "Some Sales of State Tax Credits" in the April 2007 *NewsWire* and "Purchasers of State Tax Credits" in the February 2010 *NewsWire*.)

The Joint Committee on Taxation staff said any such result was not intended in this case. Congress intended that tax credit buyers would not have to report any income. It may make this clear in a "blue book" that is expected this spring. A blue book is a general explanation of the tax legislation that Congress enacted in the previous year.

Finally, the Inflation Reduction Act is unclear about who gets audited and has to pay any audit adjustment where tax credits have been sold.

The market assumes that the IRS will come after the seller for any taxes that have to be paid after a recapture or disallowance of sold tax credits. However, the Treasury must confirm this. It would make sense to pursue the buyer in cases where the buyer claims more than the tax credits it purchased. The Inflation Reduction Act requires the seller to notify the buyer of any disposition of the project that triggers ITC recapture and then for the buyer to notify the seller the amount of tax credits that were recaptured.

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