Renewable Energy Tax Credit Finance Series: Elective Pay Final Regulations

In the latest installment in Tax Credit Tuesday's recurring Renewable Energy Tax Credit Finance series, Michael Novogradac, CPA, is joined by Tony Grappone, CPA to discuss final regulations concerning the elective pay option for certain renewable energy investment tax credits. The Internal Revenue Service published the final regulations in the March 11 Federal Register to adopt and codify temporary regulations issued in June 2023, with slight modifications. Learn about the elective pay final regulations, how they differ from the temporary regulations, potential penalties for excessive payments and the impact of other financing on elective pay.

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Transcript

Introduction

[00:00:15] **Michael Novogradac, CPA**: Hello, I'm Michael Novogradac, and this is Tax Credit Tuesday. This is the April 9, 2024, podcast. As those of you watching on YouTube can see, I'm joined by my partner, Tony Grappone. And that means, as you can probably guess, that if you finance or develop renewable energy facilities, you're in the right place.

This is Novogradac's latest installment in our Renewable Energy Tax Credit Finance podcast series. We launched this series last year to help the renewable energy industry stay current on the latest developments, as well as to serve as a resource to learn more about a variety of renewable energy structuring and financing issues and opportunities.

So let's turn to today's episode. Today we're going to cover the recently released elective pay final regulations for renewable energy investment tax credits. By elective pay, I'm referring to the option that qualifying tax-exempt have to elect to receive a tax refund of qualifying renewable energy tax credits.

Now the IRS issued the final regulations about a month ago on March 11. The proposed and temporary version of the regulations were released back in June of 2023. The final regulations did incorporate some of the many comments received by Treasury on the proposed and temporary regulations. But let's step back in time a bit.

Congress created this elective pay option for qualifying tax-exempt entities as part of the Inflation Reduction Act of 2022. Now, before the Inflation Reduction Act, tax-exempt owners had only three choices if they developed renewable energy property that was eligible for federal tax credits. The first, and the most common, was tax-exempt owners could syndicate their tax credits using traditional tax equity structures.

The second, and it was a bit rare, they could use those tax credits to offset taxes on unrelated business income. And the third, which was pretty uncommon except for real small installations, simply leave the tax credits unused. Now, with elective pay, eligible tax-exempt owners have a fourth option, a federal income tax refund.

I'll also note a bit here about the language. Elective pay is often referred to colloquially as direct pay or the tax refund option. So just think elective pay, direct pay, tax refund option, we're referring to the same thing. Now, as I mentioned, the IRS issued the proposed and temporary version of these regulations this past June, and many industry stakeholders provided comments on the proposed regulations.

And as you're probably aware, and certainly not surprised, the Novogradac Renewable Energy Working Group also submitted comments and testified at the hearing. Now today, we're going to focus on some of the key takeaways, now that the elective pay regulations have been finalized. We're also going to answer several frequently asked questions by clients and other industry stakeholders about these final regulations.

So if you're a tax-exempt entity that owns renewable energy property, or if you work with a tax-exempt entity that fits that description, this is a great episode for you to listen to and to share with your colleagues. If you're ready, let's get started. Tony, welcome back to Tax Credit Tuesday.

[00:03:37] **Tony Grappone, CPA**: Thanks Mike. It's good to be back for this installment, number seven of the Renewable Energy Series.

[00:03:43] **Michael Novogradac, CPA**: That makes you the Mickey Mantle of this podcast.

[00:03:48] **Tony Grappone, CPA**: Exactly. Let's hope for many more.

Effective Date of Final Regulations

[00:03:50] **Michael Novogradac, CPA**: Yes. Yes, indeed. So we've been getting some great feedback from our audience on this Renewable Energy Series and the renewable energy industry, as you know, firsthand continues to evolve in light of new regulations, emerging structures and the like.

So let's dive into the topic of elective pay. Now I mentioned that the final regulations were released on March 11. Those final regulations have an effective date. If you could describe the effective date, as well as how this effective date of the final regulations will affect those transactions that have been in progress, and were relying on the proposed regulations, the proposed and temporary regulations.

[00:04:35] **Tony Grappone, CPA**: Sure, great. Thanks, Mike. So, as you noted, the final regulations were issued March 11, and therefore they're effective from that date forward. However, for taxable years that ended before March 11, 2024, taxpayers could still choose to apply the proposed regulations, which were issued back on June 14, 2023.

Understanding the Pre-Filing Registration Process

[00:04:57] **Michael Novogradac, CPA**: Great, thank you for that. Now, in preparing for the podcast, you and I both noted how the final regulations largely mirror the proposed regulations, but they do clarify certain aspects of the proposed regulations, one of which involves the pre-filing registration

process for eligible entities. So if you could explain what this pre-filing registration or this pre-registration process entails, that would be really helpful for our listeners.

[00:05:24] **Tony Grappone, CPA**: Sure. Right. So there's still, you know, this is a new program and so you still have, there's still a lot of areas of clarity that are needed for the industry. And, and so one of the nice things that the final regulations did was clarify that if you want to participate in the elective pay process, there's a pre-filing registration process that a taxpayer has to participate in. And so what that means is there's an IRS portal that they can access and the taxpayer goes through that IRS portal and provides certain information about their tax credit property and then in response to that the IRS will review and hopefully provide them with a registration number associated with that particular tax credit property.

[00:06:08] **Michael Novogradac, CPA**: And is there anything you can tell us about this pre-filing registration process since your final regulations were issued?

[00:06:15] **Tony Grappone, CPA**: Right. Yeah, definitely. So, if you're a, if you're an eligible tax-exempt taxpayer, you can participate, you can start that pre-filing registration process as early as the first day of the tax year following the year that you place the energy property in service. And I'll also note that the IRS recommends taxpayers register at least 120 days prior to filing the return where you're actually seeking your elective payment.

[00:06:43] **Michael Novogradac, CPA**: And then when we were discussing the and preparing for this podcast, we talked about how often a taxpayer needs to register their property with the IRS. You would think you just register the property once. Is that not the case?

[00:06:57] **Tony Grappone, CPA**: Yeah, that was kind of surprising to, I think, everybody in the industry. You know, for ITC property, obviously, you're going to, you're going to register one time to, to file for that tax credit.

However, if you have multi-year tax credit generating property, like the PTC, the final regulations confirm that you, taxpayers need to participate in that registration process every year. You get a new registration number for each year of the tax credit period. So, I think some people were disappointed by the administrative burden of having to actually register each year of your tax credit period.

[00:07:33] **Michael Novogradac, CPA**: So, you mentioned some of the advice that the IRS has shared in terms of registering at least four months from when you file your tax return, long after you place the property in service. Could you elaborate a bit more with respect to some other tips or suggestions you have for eligible entities that they should keep in mind about this pre-registration process?

[00:07:53] **Tony Grappone, CPA**: Yeah, I think one thing that I think people just want to keep in mind is that the IRS will review what the taxpayer submits for registration submission, and then the IRS will reply with the unique registration information. But if you're the taxpayer, you want to monitor that communication with the IRS, because if you don't provide all the information that's required, the IRS can and has warned that they will reject these registration submissions.

[00:08:20] **Michael Novogradac, CPA**: Yeah, thank you. There's a lot of times when you're registering things, you've got to make sure that you're monitoring the responses.

[00:08:25] **Tony Grappone, CPA**: Right.

Elective Pay and Tax Returns

[00:08:26] **Michael Novogradac, CPA**: So you, you know, don't get surprised later. Now, there was some confusion regarding eligible tax-exempt entities or eligible entities that are generally not required to file returns with the IRS.

And if they're eligible but don't normally file returns and there's not a return, they're going to file the claim to refund. So which form do they need to file to request this elective payment?

[00:08:49] **Tony Grappone, CPA**: Right. Yeah, good question. So there are some types of tax-exempt organizations out there that aren't required to file federal income tax returns.

And so those types of entities, we're wondering if the IRS was going to create a new type of form specific to just the elective payment. But one of, but the final regulations confirm that if you're one of these types of tax-exempt organizations, you are to file an IRS Form 990- T in order to seek your elective payment.

[00:09:21] **Michael Novogradac, CPA**: Right, thank you. And while we're talking about filing a return, and this is a wonky tax accountant question, but it's one that, you know, a taxpayer might want to be aware of., Clearly, you can claim it on your originally filed return. The question that often will come up in the tax world is, can you know, claim a credit or, you know, opt for elective pay on an amended return, or does it have to be on the originally filed return?

[00:09:50] **Tony Grappone, CPA**: Right. Right. So, you know, again, this is another question that a lot of industry stakeholders were curious about, and it was clear enough in the proposed regulations. However, certain stakeholders still ask the IRS for just final confirmation or clarity around this matter. And the IRS has made it clear that you can only seek an elective payment on originally filed return.

And you can't request that elective payment later on an amended tax return.

Comments on Proposed Regulations

[00:10:20] **Michael Novogradac, CPA**: Right. Thank you for that. And I would just note for our listeners, when you think of an originally filed return, there can be substituted returns, like, there's a lot of complexity to something as simple as an originally filed return.

If you file the return and you didn't claim it, you think you may want to, please reach out to a tax accountant to see if it's, not too, it may not be too late. Now, the proposed regulations did provide that a partnership could opt for elective payments. However, those proposed regulations only allowed a partnership to apply for elective payments in a narrow range of energy tax credits.

Namely carbon sequestration, clean hydrogen and advanced manufacturing tax credits. Now, a number of commentators on the proposed regulations asked Treasury to expand the energy tax credits that would be eligible for elective payment via partnership. Drumroll, please. Please share with our audience how Treasury responded.

[00:11:23] **Tony Grappone, CPA**: Right, right. Excellent. Yeah. So, you know, again, industry stakeholders are just looking to maximize the flexibility of the program and trying to find ways where tax-exempt organizations could work with partnerships in a more collaborative manner here.

And so through that, they asked for just, you know, greater optionality with respect to the elective payment, and that included opportunities to work with partnerships. However, the final regulations did confirm that pass through entities, you know, for example, partnerships can really only qualify for an elective payment for credits provided for, through the credits that you mentioned, the Section 45V credit for clean hydrogen, the 45Q credit for carbon sequestration, and the 45X credit for advanced manufacturing.

[00:12:06] **Michael Novogradac, CPA**: Sticking with comments on proposed regulations, commentators also requested that tax-exempt entities be allowed to request some portion of their elected payment amount be refunded to them before they actually file their tax returns for the given year. Now, this request was obviously driven by a desire of tax-exempt entities to reduce the interest expense that a project is going to incur having to wait for the federal refund. In essence, to lower their total project costs.

Where did we land on that?

[00:12:42] **Tony Grappone, CPA**: Yeah, exactly. You know, so if you think of the Section 6418, you know, tax credit transfer provision, and you compare that for a moment to 6417, which covers what we're talking about here, which is the elective payment process. With 6418 and transfer tax credits, a taxpayer can monetize that credit, you know, as soon as they place the facility in service, really, OK?

However, with elective pay, a taxpayer can't obtain that elective payment until they have filed their tax return. Which, so just to kind of, you know, just sort of illustrate this a bit further, let's imagine you're a tax-exempt organization with a calendar year end. You place your facility on service of say, Jan. 1, or the first day of your tax year, and let's imagine that's Jan. 1, 2024.

Well, you have to wait till your tax year closes, so you've waited the whole year till the end of the year, and then you have to wait longer to file your tax return. And as, you know, most nonprofits I know typically file their return on extension, which means they're not filing their tax return for, you know, somewhere around 18 months following when they actually placed the facility in service.

So obviously that's a really long time that you'd have to sort of wait for that elective payment. You know, there's usually carrying costs associated with construction loans and so forth. It's just some kind of cost of financing to carry that payment. And so it really puts the elective payment and the transfer tax credit somewhat on level playing fields here.

And so, naturally, industry stakeholders try to get Treasury and the IRS to come up with some other way to shorten that timeline, that gap from when a facility is placed in service to when they can receive the payment. And one of the ways that they sought relief there was through this concept of being able to receive the payments in either installments or at least some portion of their total payment request earlier.

Unfortunately, however, the final regulations confirm that you can only receive the payment once, and it's only paid out following the filing of a tax return. And so I think one, you know, negative in the, in this whole process is that although tax-exempt entities have the option of getting elective payment, which is a huge win for that segment of the industry, it's still frustrating to know that they have to wait so long to get their payment.

[00:15:15] **Michael Novogradac, CPA**: So given that the elective pay means a tax-exempt entity has to wait as long as 18 months or more after the property is placed in service, and that's just a follow-up return, making them eligible, not to say when they'll actually get the refund. So there's a, that's a long time to wait. And given the current interest rate environment, it has a notable cost, you know, obviously in the past when interest rates, short-term interest rates were a lot lower, maybe the cost wouldn't be as much.

Now, it's a more notable percentage of the value, and given that if a tax-exempt entity goes down an elective pay approach, as we discussed in prior podcasts, they're not getting the benefit of syndicating the tax depreciation, so they're not getting value from the tax depreciation. Which brings me to a long-winded question of, do you still expect most tax-exempt entities to continue to syndicate renewable energy tax credits as opposed to go down the elective pay route?

[00:16:14] **Tony Grappone, CPA**: Yeah, I do. We have clients that are tax-exempt organizations that are eligible for the elective payment. However, some of the projects they have are, they're big enough where the value of the depreciation benefits are really meaningful and the carrying costs that you alluded to before are significant when you factor in the delay and when you would actually place your facility in service.

Up until the point you receive your payment, you know, the projects these tax-exempt organizations are building are big enough to really justify pursuing kind of more your traditional tax equity ownership structures to accelerate the timeline that they monetize the credits, but then also make sure that they're getting the value of those tax depreciation benefits.

[00:17:03] **Michael Novogradac, CPA**: Definitely going to be interesting to see how popular the elective pay is. And it just reminds you of 1603 grants back in the day when, you know, taxpayers ended up going down that route, many ended up regretting it. And so it's going to be interesting to see how this develops over time. I will say that it's clearly a great benefit for a smaller nonprofit that's doing a smaller solar installation that they themselves can, you know, the cost of syndicating the depreciation of all the rest of this isn't worth it.

And I've seen firsthand situations where they ended up passing on the tax credit just because they couldn't use it and any sort of syndication structure wasn't valuable enough. So it's definitely a feature. It's just a question of what the uptake will be, but interesting to see in a few years what, you know, IRS data shows about the use of this option.

[00:17:56] **Tony Grappone, CPA**: Agreed.

Potential Penalties for Excessive Payments

[00:17:57] **Michael Novogradac, CPA**: Now, another question that we often get asked is what are the potential tax penalties that the IRS could assess if they assert that an eligible entity has claimed too much in energy tax credits, in essence, that they challenge some of the tax credit basis and as such, the amount of tax credits and as such, the amount of the refund.

If you could share with our audience what we know now. It's not entirely clear, but if you could share what we know now about the potential for tax penalties.

[00:18:27] **Tony Grappone, CPA**: Yeah, definitely. Yeah. So this is a hot topic. Excessive payments. So in terms of excess, this is referred to as excessive payments, where the IRS makes a determination that they paid more of an elective payment than they should have.

OK. And so as far as excessive payments go, the final regulations confirm that if the IRS determines that a taxpayer received an excessive payment, then the taxpayer's federal income tax for the year in which the determination was made is increased by 1) the amount of the excessive payment and 2) increased further by a penalty equal to 20% of the excessive payment. So, that's not a small number. and of course, you know, one, one way you can sort, a taxpayer can sort of, avoid that penalty is if they can demonstrate reasonable cause under that situation. But if a taxpayer is unable to determine a reasonable cause, then, you know, you're looking at a 20% payment, you know, 20% of the excessive payment as a penalty.

Impact of Other Financing on Elective Pay

[00:19:29] **Michael Novogradac, CPA**: OK. So, I wanted to move on to the affected other financing. So, what impact can have on the calculation of the tax credits that are eligible for this elective pay? Many tax-exempt entities will use grants, forgivable loans, or other tax-exempt income to finance renewable energy property. And how does the use of some of these other financing sources affect the elective pay refund amount?

[00:19:55] **Tony Grappone, CPA**: Great question. So, you know, generally speaking, if a taxpayer, receives a tax-free grant to finance tax credit eligible property, well, you normally have to reduce your eligible basis by the amount of that tax-free grant. OK. I think one favorable aspect to the final regulations here is that a tax–in this case here with elective pay–a taxpayer can finance the construction costs using tax-free grants, forgivable loans, and other forms of tax-exempt income, and that does not reduce their eligible basis. However, there is what the IRS refers to as a no excess benefit rule. And the no excess benefit rule essentially serves to reduce the amount of the credit to the extent the credit, plus the sum of the grants, forgivable loans, and other tax-exempt income exceeds the cost of the investment related property.

[00:20:52] **Michael Novogradac, CPA**: Yeah, that's a very important point, both the excess benefit and the fact that grants and others don't reduce your basis, because that is something that could skew some transactions to the elected pay route as opposed to the syndication route.

[00:21:06] **Tony Grappone, CPA**: Indeed, that's right.

[00:21:09] **Michael Novogradac, CPA**: So I also wanted to ask you a question that we continue to receive. And that's whether an eligible tax-exempt entity that went out and purchased energy tax credits, as you mentioned before, pursuant to Section 6418, under this code section, a tax-exempt entity could go out and purchase tax credits. And then the question that keeps coming up is whether or not they could then apply for an elective payment of one of those purchase tax credits. So do you want to answer this question once and for all?

[00:21:43] **Tony Grappone, CPA**: I'll try to. I'm going to try and answer this question once and for all, but I wouldn't be surprised if we do continue to receive it. And so this is an interesting question because it's just hard to imagine a scenario where this would actually unfold on a real transaction.

But you know, project financiers are known to be creative. And so they probably just want to, you know, really just understand all their options in every scenario. So I get it. All right. So this concept, Mike, is referred to in the industry as chaining. OK. And by chaining, what they're referring to is kind of like you alluded to, you've got a partnership that generated credits, elected to transfer the credits, elected to transfer the credits, and the buyer in this case would be an applicable tax-exempt entity, the tax-exempt entity purchases the credits, and then the tax-exempt entity goes and tries to claim those credits on their tax-exempt return for a refund.

OK, and again, this is referred to as chaining. And so, the IRS, the final regulations confirm that chaining is not an option an allowable event to take place here. You cannot, a tax-exempt organization can't claim an elective payment using credits that they purchased through a 6418 tax credit transfer arrangement.

[00:22:59] **Michael Novogradac, CPA**: And I think you mentioned that, you know, it's one of those questions that people ask, but it's hard to see from a finance perspective why it would materialize. It's why would it be something that someone would actually look at and think this is the better execution. And I assume, you think it's principally just because if you actually are a taxpaying entity, they can use the credit when you buy the credit.

You at least get to start reducing your estimated tax payments, so the time value of money begins when you buy the credit, and you get a value for it at that point in time, versus buying it and waiting as much as 18 months or longer to actually get a refund from the IRS, so it's one of those where you would say, well, that seems the worst possible execution.

But still, we're getting the question. Was there any other reasons why you wouldn't expect to see it beyond that pretty basic one?

[00:23:52] **Tony Grappone, CPA**: Yeah, you know, I mean, here's an example. You know, we've got, I've seen some nonprofits where they have the nonprofit arm of the organization and then they have a for-profit arm.

OK. And so I could see a scenario where you've got the for-profit arm develops a facility, brings it to mechanical completion. Right. Uses a tax structure, you know, with a tax partnership structure to place the facility in service. And then instead of going to find a traditional tax equity investor, they transfer the credit to the tax-exempt affiliate.

[00:24:27] **Michael Novogradac, CPA**: Right.

[00:24:28] **Tony Grappone, CPA**: So I could maybe envision a scenario like that. I guess, again, would I expect to see it in frequency? Not really, but.

[00:24:37] **Michael Novogradac, CPA**: Yeah, more, it seems like it might be an accidental or a backup when some, when other situations fail.

[00:24:44] **Tony Grappone, CPA**: Exactly.

Concluding Tips on Elective Pay

[00:24:46] **Michael Novogradac, CPA**: So, thank you for that. And before we wrap up, I did want to give you a chance to share some concluding thoughts or tips regarding elective pay.

And in part, I'd probably suggest that you talk about cost segregation services and the important role they can play in a renewable energy transaction.

[00:25:08] **Tony Grappone, CPA**: Definitely. Sure. Yeah. So, yeah, and this applies to, you know, any kind of renewable energy transaction, whether you're doing an elective pay, transaction or a regular tax equity structure.

So, you know, one valuable service that we offer here is with respect to cost segregation services. And so if you're a tax-exempt organization and you own an energy property and you're looking to seek an elective payment, one thing that we can help you do is analyze your various construction and development costs.

We can help you segregate those costs into your eligible tax credit categories, as well as your depreciable life categories, intangible asset, and so forth. And I think for a lot of tax-exempt entities that don't really specialize in tax credit related work, I think they find that cost segregation study to be a very useful deliverable because they get that it helps them understand the value of their credits, helps them maximize the value of their elective pay credits.

And then it's also a great deliverable that they can also hand to. Whoever's preparing their tax return, whether it's Novogradac or somebody else, but, you know, it's good support to hand off to your tax preparer as well.

[00:26:22] **Michael Novogradac, CPA**: And then also, for those that are going down the syndication route to identify what your tax depreciation will be.

[00:26:29] **Tony Grappone, CPA**: Right, so we prepare cost segregation studies, you know, very routinely on traditional tax equity structures. Most tax equity investors require that, you know, a third-

party specialist like Novogradac prepare a cost segregation study whenever they're investing in a tax equity transaction. So we provide that service very routinely on traditional tax syndication deals.

But I'd like to point out, too, for our tax-exempt entities, because if they're not familiar, you know, if they're kind of new to renewable energy tax credits, and they're trying to, and they're struggling with how to figure out how to maximize the value of their elective pay credits, I just want them to know that we can help them do that by, by providing a cost segregation study.

Wrap-Up

[00:27:12] **Michael Novogradac, CPA**: Right, and to avoid overpayment penalty, so you're getting your credit accurately determined. So, thank you, Tony. please do stick around for our Off-Mike section. I want to hear your industry shout out for the week. And to our listeners, I will share Tony's contact information in today's show notes, so you can contact him directly with any questions you have or other observations.

Also, I'd encourage you to reach out to Tony to join our Renewable Energy Working Group. I'll include a link to the Renewable Energy Working Group in the show notes as well. As part of that, I'll include a link to some of the many comment letters. That our Renewable Energy Working Group has submitted, and then I'll also include links to previous episodes in our Renewable Energy Tax Credit Finance series.

And I also wanted to let our listeners know that we do have a dedicated playlist on our YouTube channel that have all of the episodes in this series. This will be added to it. I'd encourage you to check out that series. You can feel free to binge watch on YouTube, and I'd also encourage you to share the list with your renewable energy colleagues.

Off-Mike

[00:28:28] **Michael Novogradac, CPA**: So now let's turn to our Off Mike section, and this is originally Tony's idea, and it's turned into a really fun segment where we acknowledge our industry colleagues. So Tony, who's your industry shout out for the week?

[00:28:43] **Tony Grappone, CPA**: Great. Thanks, Mike. So, you know, in light of elective pay and tax-exempt entities, I thought of a long-time client of the firm.

It's an organization called Citizens Enterprises. Citizens Enterprises was founded by Joe Kennedy. That's right, of the famous Kennedy family. Citizens primarily aids, they're a Boston-based company. They primarily aid poor and elderly households in Massachusetts and internationally by organizing

projects to provide discounted home heating, but they also own a solar and battery storage company, which has been a long, again, a long-time client of Novogradac.

And although they are able to seek elective payments, they generally prefer using traditional tax equity structures because of the reasons we noted earlier, which allows them to monetize not only their tax credits, but also the value of the depreciation. My shout-out of the week goes to Brian Morrissey, who is the head of Citizens Enterprise's solar and battery development business.

He's been working with Novogradac for probably 15 to 20 years now, one of the firm's first renewable energy clients. And since then they have developed, just many projects, right here in New England, but all across the country as well. And, they're a great example of a nonprofit, clean energy companies that are really mission-oriented and putting together really great projects.

[00:30:14] **Michael Novogradac, CPA**: Great. I'll echo my shout out as well. Thank you, Tony. And to our listeners, I'm Mike Novogradac. Thanks for listening.

Additional Resources

Email

Tony Grappone

Working Group

Renewable Energy Working Group

Comment Letter

RE Working Group Letter to IRS about Additional Guidance on Elective Payment of Applicable Credits

(Aug. 29, 2023)

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