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Hurdles for Individual Investors in Renewable Projects

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Tax issues for individual investors in renewable energy projects are complex and the availability of the tax benefits for individuals investing in such projects are extremely fact specific, and therefore highly dependent on the individual's particular tax and business situation.

The issues primarily revolve around the at-risk and passive activity limits, neither of which apply to widely held C corporations, which is why such corporations historically have been the principal investors in renewable energy projects.

This month, we will review the tax liability and at-risk limits applicable to individuals investing in solar projects. Next month, we will focus on passive activity limits.

Individuals can invest in renewable energy, but they should understand whether the limits discussed herein will apply to them and, if so, how those limits will affect the timing or availability of any of the income tax benefits that typically apply to investors in renewable projects. Given the scalability of solar versus wind projects, most individual investors have focused on solar projects only. The following discussion is limited to solar projects.

The tax benefits for renewable investors include the Internal Revenue Code (IRC) Section 48 credit in the year the project is placed in service, but also the fact that most of the costs of a solar project can be written off under the bonus depreciation rules in the first year. These are two significant benefits that can provide a significant amount of income tax savings. Note that the IRC Section 48 solar credit is in the process of being reduced over a number of years from 30 percent down to 10 percent.

Example 1: Assume an individual invests $1 million in a solar project in a year where the tax credit is 30 percent. They finance their investment with $200,000 of equity and a nonrecourse loan of $800,000. The IRC Section 48 credit of

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$300,000 (30 percent times $1 million) will be available in the year the project is placed in service. The costs of the project eligible for depreciation must be reduced by 50 percent of the credit, or $150,000 in this example, reducing the depreciable cost to $850,000, all of which is likely deductible in the first year under the bonus depreciation rules of IRC Section 168(k). Assuming this individual is in the maximum 37 percent federal income tax bracket, their $200,000 investment can theoretically produce maximum first-year federal income tax savings of $614,500, which is the total of the $300,000 tax credit plus write-off of the $850,000 remaining tax basis, producing 37 percent of additional tax savings. For individuals in lower tax brackets, the tax savings will be less.

Seems like a “no-brainer,” right? If it were only so simple! When you analyze the tax issues that this investor must negotiate in order to generate these savings, the analysis is extremely complex and not for the timid investor. The hurdles include: (a) tax liability limitations; (b) at-risk limitations; (c) passive activity limitations.

In addition, any time an individual taxpayer includes significant losses or tax credits on their return, the risk of an audit by the IRS increases. So do not be surprised if an individual who takes substantial renewable credits and losses from a renewable project has their tax return selected for audit by the IRS. It is one thing to pay back the benefits to the IRS that the individual took on their return, but there is also the risk of penalties if the decision to take the credits and losses do not satisfy the applicable standards to avoid penalties, discussion of which is beyond the scope of this article. Consult a good tax advisor.

Tax Liability Limits

If, after applying the at-risk and passive activity limits discussed below, the IRC Section 48 tax credit can be taken by the individual investor, the amount of credit that can reduce the individual’s tax liability is limited under IRC Section 38 to offsetting approximately 75 percent to 85 percent of the taxpayer’s tax liability (before any credits). If the taxpayer has other tax credits available, they should consider how that might affect the use of any solar credits. The taxable income of the investor is reduced first by any deductible losses for the project (but potentially limited as discussed below). Note that the loss from depreciating the solar asset is deducted before the tax credit is taken. Any excess credits can be carried back one year and carried forward 20 years, subject to this same limit in each year. Note that credits that are separately limited by the passive activity rules (discussed next month) can only be carried forward and not back. In the year that passive credits are no longer subject to the passive activity limits, the credit is subject to the tax liability limit and the one-year carryback and 20-year carryforward rules apply thereafter.

At-Risk Limits

There are two separate at-risk rules that need navigation. First, IRC Section 49 applies an at-risk calculation to determine the amount of tax credits that the investor is eligible to take. Second, IRC Section 465 applies a separate at-risk calculation to the amount of net losses from the solar project that the taxpayer can deduct. These rules are applied before application of the passive activity limits discussed below.

There are rules regarding the costs that are eligible for the IRC Section 48 credit that are beyond the scope of this article. Whatever costs are eligible for the credit also must be at-risk under the rules provided by IRC Section 49 in order for taxpayers to take the credit. These rules are more liberal than the at-risk rules under IRC Section 465 for deducting losses, as they allow up to 80 percent of the eligible tax credit costs to be financed with nonrecourse financing. Such

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nonrecourse financing must be either from a federal, state or local government agency, or from a lender who is regularly and actively engaged in the business of lending money. Additional restrictions apply as well but most can be navigated without too much trouble. There is also a second type of financing available in the form of a "level-payment" loan but such financing cannot exceed 75 percent of the tax credit base.

For partners in a partnership, the IRC Section 49 at-risk rules are applied at the partner level. This means that the individual partner's slice of the partnership's capital stack must comprise no more than 80 percent (or 75 percent in the case of a level-payment loan) qualified commercial nonrecourse financing with the remaining 20 percent (25 percent in the case of a level-payment loan) consisting of either recourse debt and/or equity from the individual investor.

The at-risk rules of IRC Section 465 are applied separately to determine the amount of losses the individual investor can deduct. These rules apply whether the individual is a direct owner of the solar project or is a partner in a partnership that owns the project. An individual can deduct losses under IRC Section 465 only to the extent they are at-risk with respect to the losses. For this purpose, an individual is at-risk only to the extent of equity or recourse debt. Accordingly, and in contrast to the at-risk rules for taking the credit, nonrecourse debt does not provide at-risk to deduct losses. Also, note that the tax basis reduction for 50 percent of the credit reduces the at-risk amount of the individual investor, as illustrated by the following example.

Example 2: Assume the same facts as Example 1. Assume the $800,000 nonrecourse loan is from a qualified lender and therefore constitutes qualified commercial nonrecourse financing. The individual is at-risk with respect to the entire $1 million cost of the project for purposes of IRC Section 49 through the combination of the $800,000 qualified nonrecourse debt and $200,000 of equity. Accordingly, they are eligible for a $300,000 IRC Section 48 credit, before the tax liability limit noted above, and before applying the passive activity limits discussed next month. Assuming there is minimal revenue and bonus depreciation of $850,000 in the first tax year, the investor can deduct only $50,000 of the $850,000 net loss (i.e., $850,000 bonus depreciation) because they are at risk only for their $200,000 equity investment minus the $150,000 reduction for 50 percent of the credit. They are not at-risk for the $800,000 nonrecourse loan.

In the next issue, we will focus on the passive activity limits applicable to individual investors in solar projects. ❖

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