Benefits, Hurdles Ahead for Transferability of RETCs

The Inflation Reduction Act of 2022 allows for the transferability of certain renewable energy tax credits, including the production tax credit (PTC) and the investment tax credit (ITC). As the renewable energy community awaits further guidance from the Internal Revenue Service, Michael Novogradac, CPA, and Josh Morris, CPA, discuss in this week's podcast the basics of transferability, including how it compares to more traditional renewable energy partnership structures. They discuss possible issues around timing and recapture, as well as anticipated guidance about transferability of renewable energy tax credits.

Summaries of each topic:

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Transcript

Introduction

[00:00:10] **Michael Novogradac, CPA**: Hello, I'm Michael Novogradac and this is Tax Credit Tuesday. This is the May 2, 2023, podcast. As we receive and anticipate guidance on aspects of the Inflation Reduction Act that was passed last summer, one of the major areas in which people are anxiously awaiting more information is about the transferability of federal renewable energy tax credits.

Now, the types of tax credits, renewable energy tax credits, that are transferable. There are nine types and they fall under Sections 45Y, 48 E, 45Q, 45B, 45U, 45Z, 45X, 48C and 30C.

Now I'm going to suspect that you're not familiar with all those code references. So more broadly, this includes production tax credits, which are tax credits based on the amount of renewable energy produced. It includes investment tax credits, which are renewable energy tax credits based on the cost of a renewable energy producing facility. It includes carbon oxide sequestration credits, which are tax credits based on the cost of producing a facility that captures carbon. There are clean energy production tax credits based on the amount of clean energy hydrogen produced. There's a nuclear power production tax credits that are eligible, clean fuel production tax credits that are eligible, as well as advanced manufacturing production tax credits, and the qualifying advanced energy project credit.

Those are all the credits that are eligible for transferability and also credits for clean transportation fuels. I don't expect you to memorize this exhaustive list, but the key point is a broad swath of renewable energy tax credits are now eligible for transferability.

I will note other types of tax credits are not, and I will also note that the Section 45L tax credit, and that's a tax credit for constructing energy-efficient housing, those credits are not transferable, and I note that because we do a lot of work with 45L credits for low-income housing tax credit and historic tax credit and other types of properties that are using tax credits.

Now it's easy to say the words "transferability of federal renewable energy tax credits" or maybe not that easy. That is a bit of a mouthful, but there are a multitude of unanswered questions as to what it means to transfer a federal tax credit.

This is unprecedented territory many ways, as there aren't very many examples where the federal government has allowed federal tax credits to be separately transferred. No surprise here: we at Novogradac have been receiving many, many calls as to how transferability will work, how it will operate, what are the mechanics. And then of course, we're getting lots of questions as to what the income tax consequences of a transfer of federal energy tax credits will be for both the buyer and what are the tax consequences to the seller. And, perhaps most importantly, the reason why these other two questions are being asked, whether or not transferability is a better option for a given transaction than traditional renewable energy tax credit monetization approaches.

I'll note the issue of transferability has also been a key topic for discussion and analysis within the Novogradac Renewable Energy Tax Credit Working Group. And if you're not a member, I would encourage you to join that working group. I will include information on our Renewable Energy Tax Credit Working Group in today's show notes.

Now we are fortunate to have joining us today my partner, Josh Morris, to discuss the topic. Josh is a partner in our Dover, Ohio, office. His specialties include the new market tax credit, historic tax credits, the opportunity zones incentive and, no surprise here because it's kind of crucial for today's discussion, the renewable energy investment tax credit and production tax credit. Josh does provide numerous professional services related to these incentives, including financial forecasting and modeling services, consulting on partnership tax structuring, financial statement audits, tax preparation cost segregation studies and compliance consulting services. All of these make him a great topic, or a great guest for today's topic.

Now, in this episode, we're first going to discuss some of the basic information that developers, sponsors and investors want to know about transferability, namely the income tax consequences to the ... first, we'll talk about the income tax consequences to the buyer, and then we'll focus on the income tax consequences to the seller, and then we'll focus on some of the timing considerations. And then more generally, if you're looking at transferability and you're trying to assess the pros and cons, Josh will share his views as to what you should be considering. Now, there is a lot to cover on this topic today, so if you're ready, let's get started.

Basics of Operation

[00:05:17] **Michael Novogradac, CPA**: So, Josh, welcome to your first appearance on Tax Credit Tuesday.

[00:05:23] **Joshua Morris, CPA**: Thanks, Mike. It's great to be here. I've listened to your podcast a ton over the years, and this is really neat for me to be your guest today. And look, there arguably isn't a hotter topic in the renewable space, so I'm very excited to discuss the key issues with you.

[00:05:37] **Michael Novogradac, CPA**: And this transferability topic is hot even beyond the renewable space. Lots of other tax credits that are wondering how this is going to work for renewable energy tax credits and whether or not other tax credits should be seeking to get similar treatment.

But we won't go into all those topics. Let's start, when I think about this question about transferability of federal energy credits, I think about the tax consequences to both the buyer and the seller or the transferor. So that would be useful for our listeners if we start with the buyer, and if you could briefly summarize the federal income tax consequences to the buyer of a federal energy tax credit as best we know them today.

[00:06:16] **Joshua Morris, CPA**: Sure, sure. Yeah. So starting with the buyer under Section 6418, an eligible taxpayer can elect to transfer all or a proportion of eligible credits to an unrelated taxpayer, and that payment must be made in cash.

The buyer would not receive a deduction for the purchase price. And a few things to also keep in mind, the credits must arise in 2023 or later. So if you've generated 2022 credits, know that these new transferability rules don't apply just yet. And also you cannot transfer credits that have been carried back or forward.

And another thing, you can only transfer the credits once.

[00:06:59] **Michael Novogradac, CPA**: And you said that the buyer does not get a deduction for the amount paid for the credit. Maybe you could discuss a bit about some of the questions around what the tax consequences of the buyer are. We know they don't get a deduction, but does use of the credit itself generate income?

[00:07:19] **Joshua Morris, CPA**: Right. Yeah, that's an excellent question. And so it is not expected here that the use of the credit here would generate an income event.

[00:07:30] **Michael Novogradac, CPA**: And I would just note there, we have gotten some questions from some tax attorneys as to whether or not the lack of deduction means there's no income. And it certainly seems that the intent of no deduction is to say there's no income or loss consequence on the use of the federal credit. And some believe we need more clarification on that.

So we mentioned that the purchase of a credit, that there's no tax deduction and there are other credits where you invest equity into a partnership. You get tax credits and you get tax losses, so in that scenario, you end up paying, if you will, for both the credits and some of the tax losses here. There's no tax consequence beyond the credits. So maybe you could discuss the implications that has on pricing.

[00:08:16] **Joshua Morris, CPA**: Yeah, absolutely. So under this type of a transaction, you truly are only selling tax credits. There are no other benefits derived by the buyer, and most notably, depreciation does not get monetized.

So, to your point, this creates a situation where the buyer must set the price to purchase the credit at some discount, less than a dollar. So the key question right now that is keeping folks up at night is, where will that discounted pricing land? Is it 95 cents? Is it 85 cents or is it somewhere in between?

Timing

[00:08:50] **Michael Novogradac, CPA**: So thank you for that. Now, if I'm a widely held corporation, a lot of limitations within the tax code aren't going to apply to me. But if I'm an individual taxpayer, a number of limitations within the tax code do apply to my ability to use various tax credits and tax losses.

And one area that I'm particularly interested in with respect to transferable tax credits is whether or not the credit is going to be treated as from a passive activity, or at least from a trade or business activity such that the passive activity credit and loss limitation rules apply. So if you could take a moment, Josh, and please share your thoughts on the application of the passive activity limitation rules to a purchased renewable energy credit by an individual.

[00:09:36] **Joshua Morris, CPA**: Yeah, absolutely. I love this question. This has very much been hotly debated since transferability was introduced last summer under the Inflation Reduction Act.

So without getting too technical here, historically, individual investors have very much been limited in their ability to fully benefit from investing in tax credit transactions. Section 469, for instance, provides rules for passive activity losses and tax credit limitations. Basically, as an individual, if you don't materially participate in the activity of the business and are only a limited partner, then losses and credits allocated to you can only offset passive activity income.

This has created an environment where, as you mentioned, the key investors for tax credits are widely held C corps. So when transferability was introduced, everyone has asked the question if these active passive rules will still apply. We certainly need further guidance on the matter, but the prevailing thoughts in the industry is that these rules will in fact, still be in effect. 6418A notes that the buyer of the credits will be treated as the taxpayer with respect to the credit. Based on the wording of that statute, most feel that if the buyer is to be treated as the taxpayer with respect to the credit, then they will continue to have passive loss limitations with respect to transferred credits.

Now Mike, I know you have some thoughts on this issue and how a certain new market tax credit ruling might play a role in a potential different outcome.

[00:11:10] **Michael Novogradac, CPA**: Yeah. Thank you for that. And I totally agree that the notion of being treated as a taxpayer for purposes of claiming the credit is the critical language, because you look at it and say, well, does that mean it's treated as a credit from a trade or business activity? And if so, then the passive activity rules apply to trade or business activities, not to portfolio activities.

And then the question of course is, well, if I'm treated as the taxpayer, am I treated as the taxpayer for purposes of materially participating? In which case, the passive-activity rules wouldn't put a limitation in place.

But you made reference to the new market tax credit ruling. There is a ruling that provides that an individual that invests in an entity that enables the individual to get new market tax credits and then money then flows into this community development entity to then be used for various activities that the how the new market tax credit entity, the CDE, uses the money in a trade or business activity or portfolio activity doesn't impact the treatment of the credit. The credit itself is treated as a portfolio credit, as a consequence for new market tax credits, if an individual invests and has those credits, those are treated as portfolio credits, but you don't see a lot of individual investors in new markets because they're not, they don't offset alternative minimum tax, whereas renewable energy credits would.

So if these credits are not limited by the passive-activity rules, then you would see a large number of individuals investing in energy tax credits. So hopefully the IRS will see their way to not treat them as limited by the passive-activity rules, but we'll have to see.

But there are other potential issues that come into play, tax issues. We can't cover all of them for individuals, but if you could just discuss one or two other issues that an individual investor in energy tax credits, a purchaser, I should say a purchaser, energy tax credits needs to be thinking about.

[00:13:04] **Joshua Morris, CPA**: Sure, sure. Yeah. So to further complicate things, there are at-risk rules that exist for individuals. Similar to passive-activity rules, the at-risk rules were put in place to ensure that an individual taxpayer that is benefiting from deductions or credits has real economic risk in the transaction. The Section 465 at-risk rules limit deductions for amounts that a taxpayer is not at risk for.

For instance, any losses allocated to you in excess of your equity at risk and supported by non-recourse debt would be suspended until you have at-risk basis. Now, these at-risk rules with respect to deductions are not as applicable for transferees since deductions are not monetized with transferability.

However, under Section 49, there are at-risk rules that limit the ITCs an at-risk taxpayer can claim up to the amount that is not at risk, but there is a key exception to the rule that qualified commercial financing is exempt from the restriction. Now under transferability, since the buyer is treated as the taxpayer with respect to the credits, I would expect these at-risk rules will apply.

[00:14:18] **Michael Novogradac, CPA**: So thank you for that. And we've spent some time talking about the buy side. So now, let's turn to the sales side of this transaction. What are the tax consequences, the federal income tax consequences to the seller of an energy tax credit?

[00:14:34] **Joshua Morris, CPA**: Sure, yeah. So from the seller's perspective, the sale would be treated as tax-exempt income, and there is a basis step up to the seller.

[00:14:43] **Michael Novogradac, CPA**: So that's pretty simple. Basically no gain on the transfer of the credit and it's treated as taxable income, so the partners themselves do get a step up in basis for the cash received from the sale.

I will note that when we've discussed the buy and sell treatment, we've been focused on the federal income tax consequences. There's obviously the potential for state income tax consequences as well, and we don't have time to go into those here. There's a lot of questions about that, and maybe we'll have a future podcast on the state income tax consequences of buying or selling a federal energy tax credit, but we won't do that right now.

Let's turn now to the operational rules. Practically speaking, how early or how late can a credit be transferred and when would the buyer realize the benefits of purchasing the credit?

[00:15:35] **Joshua Morris, CPA**: Right, so an exciting element with transferability is the timing for which the credit can be sold. The deadline to sell the credits is likely the buyer's due date for filing their tax return that would include the credit. And this would include tax filing extensions as well.

So for example, a project placed in service in say May of 2023 will generate a 2023 tax credit, and that credit could be sold up until the buyer's 2023 tax return is filed, say in September of 2024.

Now to draw a comparison with the tax equity structure, you have to be in the partnership before the asset is placed in service. Safe harbor rules indicate 20% of equity prior to mechanical completion, so transferability provides an extended period for the seller to identify the investor. It's really one of the key benefits of transferability.

Recapture

[00:16:31] **Michael Novogradac, CPA**: So thank you for that on the timing question. And then once it's been transferred, credit's been claimed by the buyer, another important consideration is recapture. The property has to stay in service of a certain number of years, or else all or a portion of the credit gets recaptured. So maybe you could discuss which of the buyer or seller, would be subject to recapture, and how you think some deal structures will result based upon the answer to that question.

[00:17:03] **Joshua Morris, CPA**: Right, right. So you know, logically on the surface, you would think the buyer would not have recapture risk on the credits. Once they make the purchase, since after the sale, they'll have no further involvement in the operations of the energy property would have a difficult time preventing the occurrence of a recapture event?

Now, interestingly enough, the Joint Committee on Taxation has provided a blue book a couple weeks ago that addressed this very issue. The Blue Book also offered other helpful clarity on other IRA matters, and I certainly highly recommend our listeners read through that summary.

But back to recapture, word for word, the Blue Book says the transferee filling in as the taxpayer once the transfer is complete is responsible for any amount subject to recapture. So the seller doesn't have recapture risk and is only technically responsible for notifying the buyer when a recapture event has occurred.

Now, I certainly expect that these transfers will very much be buyer-friendly, and there likely will be indemnity agreements negotiated that would shift the risk of recapture ultimately to the seller.

[00:18:13] **Michael Novogradac, CPA**: And that's no different than current monetization structures, right? Where the seller or the project developer, if they're an investor, has certain indemnity arrangements.

[00:18:26] **Joshua Morris, CPA**: That's right.

Benefits and Hurdles

[00:18:29] **Michael Novogradac, CPA**: So we've talked about the income tax consequences to the buyer. We've talked about the income tax consequences to the seller and some of the other timing considerations and recapture considerations.

What are you seeing from project developers when you counsel them as to how they're assessing or what do you advise them when they're trying to assess the benefits and hurdles of choosing a transferred credit scenario as opposed to a traditional tax credit monetization scenario?

[00:18:57] **Joshua Morris, CPA**: Right. So this is certainly the key analysis that all of my clients have been calling and asking for assistance on to transfer or not to transfer, right? That is the question.

And so let's start with the pros. As compared to tax equity, it's a simple structure with likely less transaction costs. And as mentioned earlier, there's a longer runway to identify purchaser for the credits.

Now on the other side of the table, the disadvantages, the participants lose the ability to monetize depreciation, lose the ability to step up the eligible basis to fair market value. Additionally, a seller might need to come up with financing to bridge the purchase proceeds during construction. You know, ultimately it's a math problem where it comes down to how much a seller can value depreciation. How large is the potential step up to fair market value? And how much cheaper are the transaction closing costs as compared to a tax equity deal?

[00:20:00] **Michael Novogradac, CPA**: All right. Thank you for that. Now, one of the other aspects of this discussion, I should have mentioned that at the beginning is all of our discussion is assuming that the seller and the buyer in a transfer transaction are both taxable entities. So if you could explain to our listeners why, implicit in our discussion, both entities need to be taxable entities.

[00:20:23] **Joshua Morris, CPA**: Sure. So let's quickly jump back into the code to answer that question. Section 6418 uses the term eligible taxpayer to describe both the buyer and the seller. And 6418 defines an eligible taxpayer as any taxpayer other than a tax-exempt entity. So to summarize, a tax-exempt entity will not be able to participate in the transferability of tax credits.

However, you know, it's not all doom and gloom for tax-exempt entities because Section 6417 provides an avenue for tax-exempt entities that are the direct taxpayers of the eligible property to receive a direct payment for the tax credits. Now I'll refrain myself from going any further on that point, as I expect you might have another podcast on elective pay and the nuances there.

Next Steps

[00:21:15] **Michael Novogradac, CPA**: No, we'll certainly be having, an additional podcast at some point down the line dealing with elective pay because elective pay was designed to allow tax-exempts to get the benefit of the tax credits without having to go through a monetization structure. However, when they do monetize via elective pay or basically a refund of the credits, they only get the benefit of the credits. They don't get the benefit of monetizing the depreciation or tax losses. So we're certainly finding, initially, many clients choosing to continue down the tax monetization structure because you can monetize the depreciation as well.

But enough on that topic. This isn't that podcast. That's the podcast to come. Maybe you could describe what the next steps should be for listeners that are thinking about transferability, given that we're waiting on additional IRS guidance.

[00:22:07] **Joshua Morris, CPA**: Sure. So as our listeners can very much tell, there are a lot of open questions that need some clarity. And we expect that the Treasury is going to release guidance, hopefully by the end of Q2 here.

And I do think it will likely come in two tranches as there's a lot to cover. Uh, the industry has asked that the first tranche includes the major gating issues that are currently stalling transactions. And those key open issues include, as we mentioned earlier, will the passive event at-risk rules apply to a buyer? Can a taxpayer that receives the credit through a pass-through structure, think inverted lease, sell the credits to a third party and does the buyer have a taxable event for, say, the spread on the discounted pricing? The Blue Book did appear to clarify that point at least, and notes that it is not taxable.

But it would certainly be good to get further guidance on that matter that might even work through an example.

Resources Available

[00:23:05] **Michael Novogradac, CPA**: Yes, indeed. Let's hope we get that guidance, that initial transfer guidance soon, so more transactions can start moving forward on the transferability side. So please do share with our listeners some of the resources that Novogradac offers to help them navigate their questions about transferability and monetization structures.

[00:23:25] **Joshua Morris, CPA**: Yeah, sure. Pick up the phone and give your favorite Novo professional a call. We can help you with your financial modeling, deal structuring needs, and specific to this discussion, assist with analyzing the differences between a tax-equity structure and a transfer arrangement. Additionally, there are a few creative hybrid structures that a lot of folks are talking about and contemplating, and I'd love to tell our listeners more about that as well.

And, separately, if you haven't signed up already, go to our website and register for the Novogradac 2023 Spring Renewable Energy and Environmental Tax Credit Conference. This is taking place two weeks from now in San Diego. The main conference is May 18th to 19th, where all things IRA will be discussed.

And the day before the conference on May 17th, we have a tax equity workshop. We're going to go through the basics, some advanced technical topics and we're also going to walk through partnership flip and inverted lease models. It's really a fantastic agenda. And finally, I should also mention that we have a Renewable Energy Working Group that offers insightful discussions on all of these IRA matters.

Exit

[00:24:37] **Michael Novogradac, CPA**: Super. Thank you, Josh. I will include your contact information in today's show notes so listeners can reach out to you with specific questions. And do stick around for our Off-Mike Section where I get to ask you for some fun off-topic recommendations and words of wisdom.

And to our listeners, be sure to tune in to next week's podcast where we'll take a closer look at new market tax credits and small business loan funds. We'll discuss some of the reasons why a community development entity might want to consider pursuing a small business loan fund for using their allocation.

My partner Greg Clements and I will discuss the need for a strong pipeline as well as some of the hurdles CDEs might face when choosing to do small business loan funds.

Also, if you have any questions you'd like us to cover during that episode, please email me at CPAs@novoco.com.

Off-Mike Section

[00:25:27] **Michael Novogradac, CPA**: So now I'm pleased to reach our Off-Mike Section where I get to ask Josh for some fun off-topic recommendations and words of wisdom.

So Josh, I'll start with something that I like asking during busy season and right after busy season particularly, what's something that helps you strike a healthy work-life balance?

[00:25:45] **Joshua Morris, CPA**: Yeah, yeah. This definitely hits home for me right now just wrapping up our busy season, which was very loaded with issuing tax return or audits and tax returns. It was quite busy and so definitely some high moments of stress during that period of time and moments where I definitely wish I had a better say work-life balance or managed it better, right?

And so I think everybody handles it differently, right? I, and, and for me, I specifically use my calendar to inform me of what's going on in my personal life and what's going on in my professional life. I'll even have calendar reminders for when to take lunch. And so, when I'm going full steam ahead and I'm very busy, it's helpful to get those reminders to kind of refocus what I should be doing and take a break.

And so it can definitely be very challenging especially when you're operating in a fast-paced environment, but very important to take good care of your mental health and you know, spend time outside of work.

[00:26:53] **Michael Novogradac, CPA**: Thank you for that. I'm a big fan of Outlook and OneNote, host of other, uh, Microsoft tools to help with managing. So I always like to ask a question about what book, TV show or podcast that you'd recommend to our listeners. And I will put bounds around it. It can't be a Novogradac book, it can't be YouTube or something else Novogradac, YouTube. It can't be YouTube. It just can't be a Novogradac, YouTube, uh, video and it can't be the Novogradac podcast. But so, with those restrictions, or governors, what book, TV show podcast would you recommend to our listeners?

[00:27:29] **Joshua Morris, CPA**: Yeah, I definitely am a consumer of some good TV shows. It's really my outlet at the end of the day to kind of decompress. And so the show I'm watching right now is "Ted Lasso." probably not a new one for a lot of our listeners, but definitely one of my favorites. And for those of you that haven't, you know, tuned into "Ted Lasso," it's about a coach who is a football coach in the United States, and he's hired for a professional soccer job in Europe, where soccer is the most important thing in the world.

And so he has no idea about soccer or even the rules and so he's really set up the fail, but you know, you kind of follow along in the story and he begins to have success and he's a very endearing character. And it's a great show. It's lighthearted good entertainment and, kind of provides some good, life lessons along the way.

And so for me, it's really been a good show that I've enjoyed a lot as I've tuned into it.

[00:28:36] **Michael Novogradac, CPA**: And thank you for that. I enjoy "Ted Lasso" a lot. I do love how he is such, so upbeat, so endearing, so positive in so many ways, and then ends up having success as well. It's really a, a nice television show and as you know, a lot of good life lessons, a lot of things worth emulating.

So thank you, Josh. And to our listeners, I'm Mike Novogradac. Thanks for listening.

Additional Resources

Email

Josh Morris

Conference

Novogradac 2023 Spring Renewable Energy and Environmental Tax Credits Conference

Working Group

Renewable Energy Working Group