Monetizing Energy Tax Credits Is Clearly Tax-Free, Unless It's Not

Skadden

04 / 20 / 23

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Paul Schockett
Partner / Washington, D.C.
202.371.7815
paul.schockett@skadden.com

Carl R. Erdmann
Counsel / Washington, D.C.
202.371.7127
carl.erdmann@skadden.com

Ginetta Sagan
Associate / Palo Alto
650.470.4664
ginetta.sagan@skadden.com

This article was published in the April 2023 issue of *Insights*.

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One Manhattan West
New York, NY 10001
212.735.3000

Key Points

- The Inflation Reduction Act includes many credits intended to reduce greenhouse gas emissions.
- New energy tax credit provisions are designed to streamline the credits' monetization and expand the market of potential participants.
- Questions remain about the corresponding state tax treatment.

The Inflation Reduction Act (IRA) of 2022 includes an estimated $370 billion of energy-related credits, marking a historic effort to reduce greenhouse gas emissions. Significant new provisions include direct payment and transferability of tax credits under Internal Revenue Code (IRC) Sections 6417 and 6418, respectively.

The provisions are intended to simplify the monetization of credits and expand the market of potential participants. However, there are a number of open state tax questions about how these provisions will apply, and in the near term, they could reintroduce complexity.

Section 6417 – Direct Pay

Under Section 6417(a), qualified entities may apply their energy tax credit amounts against taxes they owe and receive a direct payment from the government as a refund for credit amounts in excess of their taxes. All taxpayers may claim a direct payment for credits under Sections 45Q, 45V and 45X. Taxable entities may do so only for five consecutive taxable years. However, direct pay for the majority of credits is only available to tax-exempt entities and certain other nontaxable entities.

Because the direct payment is treated as a payment of tax, the general rule that governs taxation of tax refunds under Section 6402 is applicable, and the refund should not be taxable to the taxpayer.

Section 6418 – Transferability

Section 6418(a) permits the one-time sale of all or a portion of certain energy tax credits for any taxable year to an unrelated person. Cash payments in exchange for the transferred tax credits are tax-free to the seller and nondeductible to the buyer. Unlike the direct pay election, tax-exempt entities may not take advantage of transferability.

Energy Tax Credit Amendments

Beyond adding Sections 6417 and 6418, the IRA extended the existing energy tax credits through the end of 2024 and added a technology-neutral tax credit through the end of 2032. The IRA offers opportunities to increase investment tax credits and production tax credits from a base amount of 6% to 30%, provided certain prevailing wage and apprenticeship requirements are met. There are also "adders" that are stackable and can increase the rates for these types of tax credits.

State and Local Tax Conformity With the IRA

While Sections 6417 and 6418 could significantly simplify the monetization of energy credits at the federal level, the changes introduced by the IRA raise questions about the corresponding state tax treatment. State income tax systems generally use federal taxable income as a starting point to calculate corporate income tax.

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Some states automatically incorporate the IRC as it changes ("rolling" conformity), while in others, the legislature votes to adopt the IRC as of a specific date ("static" conformity).[1] In rolling conformity states, the legislature would have to pass legislation to avoid conforming to any particular IRC change.

Within the static conformity states, there is variation with respect to the conformity date. For example, California enacted the Conformity Act of 2015, which changed the state's conformity date from January 1, 2009, to January 1, 2015. Therefore, California has only adopted amendments to the IRC since 2015, upon specific legislative action.[2]

For most other static conformity states, legislation has historically been enacted to conform the state code to the IRC. For example, Arizona passed Senate Bill 1264, which advanced Arizona's conformity date to the IRC from March 11, 2021, to January 1, 2022 (and has historically done so annually). Minnesota, another static conformity state, passed legislation to adopt the IRC through 2022. Thus, IRA amendments would apply.

Potential State Tax Considerations Under the IRA

Taxpayers hoping to take advantage of the simplified energy credit monetization rules could learn that the state tax treatment of these provisions is not so clear, nor simple. In particular:

- It is unclear how direct payments under Section 6417 or cash received for transfers under Section 6418 will be treated for state tax purposes in static conformity states such as California.
- While direct payments under Section 6417 are not included in the taxpayer's federal gross income because the payment is treated as a tax refund, in a static conformity state that has not yet adopted the 2022 IRC amendments, those payments may be treated as taxable. In addition, a transferor of a credit conducting business in a static conformity state is at risk of recognizing taxable income upon such transfer.
- For state tax purposes, the purchaser of a credit could be deemed to have acquired a capital asset with a basis equal to the amount paid for the credit. As a result, when the taxpayer utilizes the credit, it may have to recognize gain on the difference between the tax liability offset by the credit and the amount the taxpayer paid for the credit.

The goal of streamlining the monetization of tax credits under the IRA provisions may not be fully realized until states adopt the most recent changes to the IRC. This will likely require, at a minimum, state legislative action in static conformity states.

Well-advised participants should enter into these types of transactions with full information about the potential state tax treatment based on their particular circumstances.

[1] There are a few states that use a hybrid approach referred to as "selective" conformity, in which they conform to only certain provisions of the IRC. Certain states also have different conformity rules for corporate and personal income tax. For example, California has static conformity for corporate income tax but rolling conformity for personal income tax. For purposes of this article, we focus on corporate income tax.

[2] Following the enactment of Section 1603 of the American Recovery and Reinvestment Act of 2009, there was uncertainty about how cash grants, which were tax-free for federal income tax purposes, would be treated in states with static conformity. California enacted legislation that exempted such cash grants from state tax.