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Transferability: IRS Guidance Energizes Participation in a New Tax Credit Monetization Strategy

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Key Points

- Changes enacted as part of the Inflation Reduction Act allow companies to purchase federal energy tax credits from third parties for cash.
- The success of these provisions, which are designed to streamline monetization of the credits and expand the market of potential participants in energy projects, will depend on the development of a robust transfer market.
- While certain technical aspects of the credit transfer process are still being worked through, the market has seen an increasing number of tax credit transfer deals since preliminary IRS guidance (88 FR 40496) was issued in June 2023.
- Companies participating in the credit transfer market are able to obtain tax savings while supporting the development of renewable technologies at a time when public investors and other stakeholders are increasingly focused on companies' greenhouse gas mitigation and other environmental efforts.

The Inflation Reduction Act (IRA) of 2022 reflected a push by Congress and the Biden administration to address climate change by broadening the applicability of tax credits traditionally available for renewable energy to new technologies (such as clean hydrogen and dynamic glass), increasing the value of credits available for other technologies (such as carbon capture), and incentivizing manufacturing of advanced technologies and mining of elements critical to those technologies.

The IRA also added provisions to the Internal Revenue Code that, for the first time, made certain federal tax credits associated with energy projects freely transferable to third parties for cash. (For more on this topic, see our June 21, 2023, client alert "Newly Proposed Regulations Provide Much-Needed Guidance on Federal Energy Tax Credit Monetization Provisions.")

The ability to purchase these tax credits at a discount to full utilization value provides a new investment opportunity for corporations in various industries that may not have previously considered investing in renewable energy projects. At the same time, the ability to transfer the credits expands the market of potential investors that project developers can look to in order to finance their energy projects.

Tax Credits as a Means of Financing Renewable Energy Projects

Going back more than four decades to the introduction of tax credits for solar projects, the construction of most renewables projects in the United States has been subsidized by federal tax credits. Particularly for technology in nascent stages (such as wind and solar power in the 1970s and 1980s, and carbon capture today), the federal government's decision to provide a subsidy in the form of tax credits has contributed significantly to the development of technologies that, absent those credits, might not have made economic sense to pursue.

Prior to the passage of the IRA, outside investment in these projects was limited to a subset of frequent market players (mostly large financial institutions) that developed strong familiarity with wind and solar technology and the economics of these projects over the course of numerous investments.

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While these investments provided a significant boon to the renewables industry, in order to claim the tax credit, investors were required to bear equity-type risk associated with the projects. That necessarily limited the participants to institutional investors with the time, resources and risk appetite to invest directly in the projects.

Expanding the Investor Base Through Transferability

Congress was aware of these market limitations and sought to address them through the transferability provisions in the IRA, which permit the one-time sale of all or a portion of certain energy tax credits for any taxable year to a third party. The hope was that, with transferability, developers of renewable energy projects would be able to reach a broader range of potential financing sources, including companies with little to no prior experience in this space.

This is possible because, unlike under pre-IRA law, a buyer of the tax credits associated with an energy project need not take any equity risk on the development or operation of the project itself. Instead, the tax credit can be purchased like any other asset, with contractual indemnities in place to protect the buyer against project-level risks that could result in the reduction, disallowance or recapture of the tax credit.

Recapture, or a clawback of the tax credit, is one of these risks and can occur in a number of scenarios, including if the project is destroyed in a casualty event or otherwise permanently taken offline. The transferability rules impose this recapture penalty on the credit buyer rather than the project owner (who will often have control over the circumstances causing recapture). In response, credit buyers typically request an indemnity from the project owner to cover this risk, as well as any other reduction or disallowance of the credit.

While the nature of the asset presents some added complexity in terms of execution of the sale (for example, credit transfers must be registered through an IRS portal that has not yet been made available to the public) and the ongoing relationship between the seller and the credit buyer, this does not appear to be a major deterrent for new market entrants.[1]

1 One side effect of the fact that recapture is imposed on the credit buyer is that the project owner, who may be contractually responsible for indemnifying the credit buyer against recapture, will generally want the ability to control aspects of the credit buyer's tax audit related to this issue. This is a common feature of tax equity transactions but may be a sticking point for new market participants unaccustomed to having another party involved in their federal income tax audits.

Early Successes

The ability to transfer energy tax credits is already factoring into many of the energy projects currently under development. This is particularly the case for projects with terms negotiated following the release of the initial IRS guidance on transferability in June 2023.

Participation by potential credit buyers that are not familiar with the energy industry or do not have direct connections with project developers is being facilitated by a number of third parties, including the large financial institutions that have traditionally participated in tax credit transactions (many of which may have potential credit buyers as clients), as well as credit brokers and other advisory firms.

Credit buyers have a critical role to play in the continued expansion of financing sources for renewable and other energy projects, making them an essential component of the IRA's success.