Inflation Reduction Act: Credit monetization proposed regulations create strategic opportunities

August 14, 2023

In brief

The Inflation Reduction Act of 2022 (Act) created, extended, and expanded certain tax credits intended to encourage production of clean energy, reduce carbon emissions, and promote domestic manufacturing. Many of these credits provide a base rate and then increase the base rate for compliance with certain social policy-related requirements, such as prevailing wage, domestic content, and location-based (credit bonuses).

Observation: This presents a strategic opportunity for companies and asset managers with a presence in the United States, including those with a focus on infrastructure, real estate, and private equity. Initially estimated at $370 billion in new energy-related tax credits over the next 10 years, recent estimates have doubled as participants and new entrants to the market realize the breadth of credits available.

Additionally, the Act creates mechanisms to allow a broader spectrum of taxpayers to benefit from the credits, either through an elective payment (as referred to in the latest proposed regulations, and previously 'direct pay' or 'refundability') under Code Section 6417 or a transferability election under Section 6418. On June 14, the IRS and Treasury released three regulation packages addressing the elective payment and transfer of energy credits: temporary regulations requiring taxpayers to register on a portal when monetizing credits, proposed regulations on elective payment, and proposed regulations on transfers. Taxpayers should carefully consider the registration requirements in relation to both Section 6417 and Section 6418. The IRS also issued FAQs and a fact sheet providing information on the regulations.

The temporary regulations apply to tax years ending on or after June 21, 2023. However, the proposed regulations state that a taxpayer may rely on the proposed regulations in tax years ending after December 31, 2022 but before publication of final regulations if it applies the proposed regulations consistently and in their entirety.

Note: The IRS guidance provides a number of new details around important logistical elements of transferability. Both transferors and transferees should analyze the nuanced eligibility requirements for these credits in the year claimed and during recapture periods. For a broader discussion on the two proposed regulations and their interplay with the temporary regulation, please see our recent Insights linked below.

Observation: One common credit monetization question for infrastructure, real estate, and private equity funds was how refundability and transferability would work in a partnership context since many partnerships are owned by both entities eligible for direct pay (i.e., tax-exempt) and entities eligible for transferability (i.e., taxable). In response, Treasury and the IRS indicated that the partnership is the relevant entity for these purposes. As a result, the proposed regulations provide that a partnership may monetize via direct payment only for credits related to clean hydrogen, carbon sequestration, and advanced manufacturing. For all other eligible tax credits, a partnership may only elect transferability, without regard to whether one or all of its partners are tax-exempt.

Action Item: As the IRS is seeking to clarify the Act in a manner that reduces uncertainty, taxpayers have been provided the opportunity to comment on provisions in the Act that currently may not be clear. The IRS requests comments from the public by August 14, 2023 for both the Section 6417 and the Section 6418 proposed regulations. The public hearings on these proposed regulations are scheduled to be held on August 21 and 23, respectively.

In detail

Background

Prior to passage of the Act, infrastructure, real estate, and private equity funds could earn certain tax credits in connection with their adoption of certain environmental, social, and governance (ESG) technologies (such as utilizing solar panels to generate electricity and installing electric vehicle car charging stations on properties). As a practical matter, however, those tax credits had limited applicability because they were nonrefundable and there could be limited tax liabilities available for the tax credits to offset.

Action item: Whether exploring market opportunities as valuations of renewable portfolios increase or investigating development opportunities to take advantage of the new incentives, asset managers should engage in appropriate diligence. The guidance released on June 14 is expected to cause a spike in activity as feasibility studies already have been set in motion, with key market players acting as guidance continues to be issued. Means of entering the market vary and generally can include the execution/investment in a green energy project or the buying/selling of tax credits.

Observation*:* While a taxpayer can only elect the Production Tax Credit (PTC) or Investment Tax Credit (ITC) with respect to a single facility, in some situations a single project may be able to elect the PTC on some assets and the ITC on other assets. When analyzing whether to claim the ITC versus the PTC, taxpayers should model out what the present value of tax credits would be based on the specific nature of the project. Items to consider may include discounts, inflation, depreciable lives, and evolving legislation impacting project cost. In addition, the risks and limits associated with ITCs and PTCs differ, and those should be taken into account as well.

Action item*:* Businesses should discuss contractual provisions and third-party agreements with their tax advisors for planning purposes within the context of - but not limited to - registration requirements, indemnity, recordkeeping, effect of lack of recordkeeping on discounts, and basis and recapture rules related to these credits.

Elective payment election proposed regulations

Background

For tax years beginning before 2033, Section 6417 allows tax-exempt organizations, states and their political subdivisions, the Tennessee Valley Authority, Indian tribal governments, Alaska native corporations, and rural electric cooperatives (applicable entities) to elect to treat certain credits that it otherwise would be eligible to claim as a taxable entity as a payment against tax equal to the amount of the credit (an elective payment election). Generally, an elective payment election is made on a property-by-property basis, generally is irrevocable, and

applies to the full amount of an applicable credit attributable to an applicable credit property. The FAQs elaborate on which entities may make the elective payment election. These entities include cities, counties, water districts, school districts, economic development agencies, and public universities and hospitals that are agencies and instrumentalities of states or political subdivisions.

Rules similar to the basis and recapture rules under Section 50 apply to elective payments of ITCs. While tax-exempt organizations generally are limited in the ability to earn ITCs, these limitations are turned off for purposes of the direct pay election. The proposed regulations clarify that, notwithstanding that an applicable entity may be a partner in a partnership (or all the partners in a partnership are applicable entities), partnerships themselves are not applicable entities. Accordingly, the only way for a credit to be monetized with respect to property held in a partnership is through a transfer of the credit.

Notwithstanding this point, all taxpayers may make an elective pay election for tax credits related to clean hydrogen, carbon sequestration, and advanced manufacturing, although for taxpayers other than those listed in the prior paragraph, such an election is only valid for the tax year of the election and the following four tax years.

***Observation**:* Although an electing taxpayer may make a direct pay election relating to clean hydrogen and carbon sequestration for up to only five years, it may transfer credits (likely at a discount) or claim the credits on its tax return for the remainder of the 10-year effective period of the credit after the elective payment election has expired (e.g., in years 6 through 10) or has been revoked (e.g., year of revocation through year 10). The period for a Section 45Q credit is 12 years rather than 10 years.

***Observation**:* Funds that have tax-exempt partners that otherwise may have been eligible for direct pay should be aware that using a partnership structure to invest in a credit-eligible project may limit the amount of credit available. Additionally, a tax-exempt partner is ineligible for the elective payment of credits if the tax-exempt partner invests in a credit-eligible project through a fund. Similarly, funds that have unblocked non-US partners also may be limited on the amount of credit available. Co-mingled infrastructure, real estate and private equity funds therefore are, beyond traditional tax equity partnerships and direct utilization of the credits, limited to transferring the credits to monetize credits (other than credits related to clean hydrogen, carbon sequestration, and advanced manufacturing). These co-mingled funds and their partners should consider any potential limitations on monetization of credits.

Elections by electing taxpayers

In general, the applicable entity itself may make the election. While this often may be the owner of the property, when credit property is owned by a disregarded entity, the regarded taxpayer is the party that files the election. When (i) property is co-owned as a tenant-in-common (TIC) or (ii) there is an election by partners to elect out of treating the entity as a partnership for federal income tax purposes, each owner would make its own election. An electing taxpayer that is a member of a consolidated group may make an elective payment election for an applicable credit. Electing taxpayers may not transfer a credit during the period when the election is in effect.

***Observation**:* TIC arrangements may provide some flexibility for tax-exempt investors wishing to receive elective payments since a partnership may not make such an election. However, TICs are not widely used in these types of investments for a variety of reasons. Taxpayers considering TIC arrangements should consider the risks, benefits and detriments (for management companies within the context of Section 1061) of investing or implementing a TIC structure.

Partnerships – application of limitations

The proposed regulations clarify that limitations on the general business credit under Section 38 and the limitations related to passive activity credits under Section 469 apply at the partner level and therefore do not affect the amount of an elective payment by a partnership.

The proposed regulations provide that tax-exempt income resulting from a partnership elective payment is treated as arising from an investment activity and not from the conduct of a trade or business for purposes of the passive activity rules of Section 469 and is not treated as passive income to partners.

Credit transfer proposed regulations

Background

An eligible taxpayer may elect to transfer, for cash, all or a portion of the eligible credits (that are determined with respect to the eligible taxpayer) to an unrelated party (within the meaning of Sections 267(b) or 707(b)(1)). An eligible taxpayer must make a transfer election, which is irrevocable, no later than the extended due date for the eligible taxpayer's original federal income tax return. An election may not be made on an amended return and the IRS may not provide relief for a late filing of an election. An eligible taxpayer must make a transfer election separately for each facility. One requirement to effectuate a transfer of a credit is that the consideration must be paid in cash and in the year of the transfer.

***Observation**:* The requirement that the consideration be cash in the year of the transfer limits the timing of the transfer of the credits.

As noted above, the direct pay proposed regulations take the position that as a partnership is not an applicable entity, accordingly, it is an eligible taxpayer for Section 6418. Consequently, a partnership may make a transfer election with respect to property it owns and not the partners. Amounts received in connection with the transfer of a credit are treated as tax-exempt income for purposes of Sections 705 and 1366.

An eligible taxpayer may transfer an eligible credit either for (1) eligible credit property held by a disregarded entity of which the taxpayer (including a partnership) is the sole direct or indirect owner or (2) the taxpayer's undivided share of eligible credit property co-owned through a TIC arrangement or through an organization that has made a Section 761(a) election to be excluded from the application of subchapter K. Eligible credits transferred are ineligible for elective payment.

The proposed regulations specify documentation that an eligible taxpayer must provide to a transferee taxpayer, which the transferee taxpayer is required to retain.

***Note**:* The proposed regulations impose, primarily on the transferor taxpayer, extensive information submission requirements at multiple stages of the transfer process, from registration through the recapture period. Transferor taxpayers should analyze these requirements and establish processes intended to meet them.

The regulations also clarify that the risk that the credits would be recaptured would fall on the buyer of the credits. However, a partner disposing of an interest in a transferor partnership bears the risk of recapture with respect to the disposed partnership interest. The seller of an ITC will have a five-year reporting obligation to the buyer for ITCs that are sold. Taxpayers should consider the practical implications of this ongoing relationship resulting from a single sale of the credits.

***Observation**:* The seller of the eligible credits and the buyer would be expected to enter into a contractual arrangement in which the seller would indemnify the buyer if a recapture event has occurred.

The proposed regulations provide that a credit can be split up and sold in multiple transactions to different buyers. However, the proposed regulations require that all buyers of a credit purchase a pro rata share of a purchased credit and that credit bonuses cannot be sold to different people. For example, one cannot sell the base credit (being 6% in the case of an ITC) to one buyer and the credit related to the domestic content bonus (being 10% in the case of an ITC) to another buyer. This limits flexibility in structuring and marketing eligible credits.

Amount of credit

The proposed regulations provide that in determining the amount of an eligible credit that is an ITC, the eligible taxpayer must apply the Section 49 at-risk rules and the Section 50(b) limitations on property qualifying as investment credit property. The proposed regulations clarify that these rules, which relate to the eligible credit property still held by the eligible taxpayer, do not apply to a transferee taxpayer.

***Observation**:* In the case of partnership transferring a tax credit, Section 50(b) may limit the amount of credit available for the partnership to transfer based on tax characteristics of the partners. Consideration should be given to the application of these rules when a partnership is determining the amount of credit available to transfer, such as the case with co-mingled funds.

The proposed regulations provide that the limitations on the amount of the general business credit under Section 38(c) and on claiming passive activity credits under Section 469 do not apply in determining the credit amount that an eligible taxpayer may transfer, but may limit the amount of the credit that a transferee taxpayer may claim. In applying the Section 469 passive activity rules to determine the allowable credit, a transferee taxpayer is not considered to have owned an interest in the eligible taxpayer's trade or business when work was completed and may not use the grouping rules to change the characterization of the transferee taxpayer's participation.

Tax implications for a transferor and transferee

Both transferors and transferees should note the significant eligibility requirements for these credits in the year claimed as well as during recapture periods. These requirements vary significantly based on, among other things, the type of credit, the amount transferred, and the type of transferor and transferee entity. Taxpayers electing to transfer credits need to be familiar with the extent of the information required for registration, making the election, disclosure to the transferee, and reporting the transfer on their return. The proposed regulations provide that a transferee taxpayer does not realize gross income when applying a transferred credit to its tax liability if the amount paid is less than the amount of the credit transferred.

***Observation**:* The consideration for the credit transferred may be less than the amount of the eligible credit as the result of discounts being applied. Discount rates may be impacted by the quality of documentation supporting credit eligibility, detail supporting credit computations including bonus rates, likelihood of recapture events, evidence that the credit amount is not excessive, and general credit transfer market conditions.

Partnerships

The proposed regulations state that the Section 49 at-risk rules limiting the ITC apply at the partner level in determining the amount of the eligible credit. The partnership must request information from its partners about their nonrecourse financing relating to the underlying credit property and report information about each partner's Section 49 limitation on the entity's tax return. A change in a partner's nonqualified nonrecourse financing after the close of the tax year in which the credit amount is determined is disregarded at the entity level.

***Observation**:* By excluding financing events after year-end from credit limitation determinations, the proposed regulations enable transferee taxpayers to evaluate whether credit amounts are excessive as of a certain date. Although the transferee taxpayer generally is subject to credit recapture, post-year changes to nonqualified

nonrecourse financing impact the partner of the transferring entity. An increase may cause recapture, and a decrease may create additional credit that may be claimed, although not transferred, at the partner level.

A partner's distributive share of the tax-exempt income is based on the partner's share of the eligible credit. Tax-exempt income resulting from the transfer of a specified credit portion by a transferor partnership is treated as arising from an investment activity and not from the conduct of a trade or business and is not treated as passive income to partners under the Section 469 passive activity rules. The consideration paid by a transferee partnership is not deductible or chargeable to capital account.

The proposed regulations provide rules for (1) allocating the tax-exempt income resulting from transferring specified credit portions of fewer than all eligible credits and (2) determining the timing of the transfer and allocation of an eligible credit to the partners.

***Observation**:* When the credit transferred is less than the allowable credit, a special rule allows partners of a transferor partnership who want to transfer their allocable portion of an eligible credit to receive cash. The portion of the credit not transferred is allocated to the remaining partners. Despite this flexibility, the partnership (and not the partners) must make the transfer election and satisfy the compliance requirements.

REITs

While the proposed regulations do not include any new guidance particular to REITs, the preamble touches on a variety of issues specifically related to REITs. The preamble indicates that proceeds received by a REIT from selling a tax credit should not impact its income tests. The preamble also provides that the general rule that amounts received in exchange for a credit are excluded from gross income applies for purposes of the REIT income tests.

Similarly, the preamble states that the receipt of (or the right to receive) an eligible credit does not result in income to an eligible taxpayer that also is a REIT. The preamble also notes that until additional guidance is published in the Internal Revenue Bulletin, in any tax year in which the quantity of excess electricity transferred to the utility company during the tax year from energy-producing distinct assets that serve an inherently permanent structure does not exceed the quantity of electricity purchased from the utility company during the tax year to serve the inherently permanent structure, the IRS will not treat any net income resulting from the transfer of such excess electricity as constituting net income derived from a prohibited transaction. The preamble notes that any sale of electricity that does not meet the test above should be analyzed on a facts and circumstances basis to determine whether the sale is subject to the prohibited transaction rules.

***Observation**:* Similar to a partnership, a REIT-transferor must affirmatively elect to transfer an energy tax credit. As with other transferring taxpayers, the proposed regulations require a REIT to make a transfer election on its original federal income tax return and to include certain forms and schedules. An election may not be made on an amended return, and the IRS may not provide relief for late filing.

***Observation**:* The preamble to the credit transfer proposed regulations is the second instance of the IRS and Treasury providing guidance on the treatment of income from the transfer of electricity to a utility company in a preamble without corresponding published guidance (the first instance being the preamble to the final regulations defining real property for REIT qualification purposes). While this position is only set forth in the preamble, it sets forth the IRS and Treasury's views on this issue. The preamble, however, does not address whether a transfer of credits "counts" as a sale for purposes of applying the prohibited transactions safe harbor.

Tax equity

The new options for monetizing the certain credits can help taxpayers unlock the value of these incentives regardless of their current tax position and can generate new financing structures and opportunities to support

these investments in addition to commonly used 'tax equity' structures. Tax equity's purpose is to monetize tax credits and other tax attributes (including depreciation) generated in the construction of qualifying energy property.

***Observation**:* While analysis and modeling are still ongoing, it appears that tax equity may remain one of the primary methods of renewable energy financing as it may complement Section 6418. Although transferability allows for credits to be monetized, it does not allow for the monetization of depreciation or other deductions, which are critical value propositions of tax equity partnerships. Currently the tax equity market is estimated at $20 billion and is expected to grow as taxpayers enter the credit market intending to monetize credits by use of Section 6418.

State tax considerations

While most states have adopted the current version of the Code, taxpayers should analyze how states that do not have rolling conformity to the Code might adopt the new provisions. For example, California generally conforms to the Code in effect as of January 1, 2015. Thus, a REIT may have additional income for California purposes that may be subject to tax if there are insufficient distributions. In addition, states that have rolling conformity might decide to pass legislation to separately decouple from specific provisions of the Code, including Sections 6417 and 6418.

Strategic next steps

The Act is intended to offer a robust platform for building owners, operators, and investors to accelerate their progress toward decarbonizing the environment and meeting their sustainability commitments. In light of potential opportunities to enhance the return on investment or to offset upfront investment costs, the Act can provide an impetus for undertaking decarbonization projects.

To tap into these opportunities, a comprehensive roadmap covering multiple steps from project inception to execution is needed. The objectives of, for example, undertaking a solar project could be multiple – reducing emissions, generating revenue, increasing property values, and attracting tenants.

Such an analysis can be complicated – energy markets and prices fluctuate, local and state governments' decarbonization initiatives are changing the grid mix, utility programs such as net metering and tariffs may adjust, local incentives can improve the returns, and a company's building structure and rooftop could impact the size of solar arrays and hence the ability to generate or sell energy. Additionally, executive buyers are often interested in knowing how such an initiative will impact the run rate of their properties. Designing a holistic and sustainability strategy, encompassing the above levers, is a crucial step.

Additional resources

For a broader discussion relating to the impact of these tax credits to asset managers, access our prior Insights:

Shed light on energy generation for your business

In depth: Accounting for Inflation Reduction Act energy incentives

Regulations address direct payment of energy tax credits

Regulations address transfers of energy tax credits

Proposed regulations on low income bonus energy credit

IRS provides guidance on energy community bonus credit

IRS provides guidance on domestic content bonus energy credit

Inflation Reduction Act: Energy-related credits may provide opportunities for infrastructure asset managers

Inflation Reduction Act: ESG provisions may provide benefits to the real estate industry

Wage and apprenticeship guidance issues for energy bonus credit

Let's talk

For a deeper discussion of how the provisions of the Act can be monetized or help meeting carbon-neutral or net-zero goals, please contact one of the PwC professionals listed below:

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