IRA of 2022: Transferable Tax Credit

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"The Inflation Reduction Act of 2022 makes the single largest investment in climate and energy in American history, enabling America to tackle the climate crisis, advancing environmental justice, securing America's position as a world leader in domestic clean energy manufacturing…"- *US Department of Energy*

"The Inflation Reduction Act of 2022 is the most significant climate legislation in U.S. history"- *US Environmental Protection Agency*

Overview

The Inflation Reduction Act of 2022 (IRA) has been heralded by numerous government departments as the most monumental legislation regarding the climate and energy in American history. This legislation has offered funding, programs and more importantly tax incentives to help accelerate the nation's transition to a clean energy economy. Intending to spur the growth and development of renewable energy, the legislation promotes accelerated redeployment of capital within the clean energy sector through the creation of transferable Investment Tax Credits (ITCs) and Production Tax Credits (PTCs). For the first time, the IRA allows for the transfer of ITCs and PTCs to corporations and individuals with passive income to reduce their tax liability which will dramatically expand the market by billions of dollars. Goldman Sachs estimates that the IRA will catalyze $3 trillion of investment in the US over the next 10 years.[1] Gaia Risk Management believes these credits will help fuel America's transition to clean energy. Our purpose at Gaia is to facilitate tax credit transfers to maximize value of the credit for both the developer of sustainable energy assets (the sellers of credits) and eligible U.S. tax payers (the buyers of credits) who are looking to efficiently manage their tax obligations while providing much needed cash the clean energy economy.

Inflation Reduction Act of 2022

In August of 2022, President Joe Biden signed into law the Inflation Reduction Act of 2022 (H.R. 5376) which included $369 billion in climate and clean energy provisions. The bill is designed to accelerate the expansion of the renewable energy usage, storage and manufacturing as well as bolster the deployment of nuclear energy. Furthermore, the bill focuses on increased access and development of clean energy in both low-income and minority communities, incentivizes the repurposing of Brownfield sites, promotes domestic manufacturing, and encourages fair and prevailing wage minimums and apprenticeship programs. Using federal tax code as a clean energy policy solution, the bill both expands and extends Investment (ITC) and Production (PCT) tax credits.

Under this legislation, taxpayers can use the ITC and PTC to deduct a percentage of the cost of renewable energy systems from their federal taxes. The bill provides for the current ITC of 30% and PTC of $0.0275/kWh to be extended through at least 2025 for projects started prior to

[1] https://www.goldmansachs.com/intelligence/pages/the-us-is-poised-for-an-energy-revolution.html

December 31, 2024. For systems place in service on or after January 1, 2025, the new Clean Electricity Production Tax Credit, under new Internal Revenue Code § 45Y, and the Clean Electricity Investment Tax Credit, under new Internal Revenue Code § 48D will replace the traditional PTC and ITC. There are also four bonus credits that have been added in this new legislation which could increase the amount of the credits, details can be found in the Appendix.

More importantly, to increase utility and accessibility of tax credits, the IRA has created significant opportunities for tax credit monetization. There are two means of monetization for both commercial and utility-scale projects introduced in this legislation:

- ***Transferability:*** This option allows project owners to monetize certain tax credits by transferring them to other taxpayers in exchange for cash. For the first time this enables direct transfer of tax credits between parties.
- ***Direct "Elective" Pay:*** This process allows income tax exempt entities, such as nonprofits, state/local/ Tribal governments, rural electric cooperatives, and publicly owned utilities, to receive a direct payment from the IRS, in the form of a tax refund for the amount of a tax credit. For the first time this enables tax-exempt entities to take advantage of clean energy credits.

Why are these changes significant, and how do they increase the accessibility of tax credits and create opportunities for tax credit producers and tax credit purchasers? In order to understand how revolutionary this legislation can be, one must first look at how tax credits were monetized in the past.

Pre-IRA: Tax Equity Financing

Prior to the passage of the Inflation Reduction Act of 2022, clean energy credits were intended to be utilized directly by the developer (solar, wind other clean energy) who would claim the credit as a subsidy for the project costs. The main disadvantage with this system, is that the developer needs to have an income tax liability in order to take advantage of the credit. For many private or public clean energy developers in the midst of working to scale up their businesses they do not have sufficient federal income tax liabilities for the tax credit to be beneficial. Furthermore, developers often are not able to benefit from the depreciation affiliated with their projects. As the developers were not able to sell or transfer these credits outright, it has led to the formation of partnerships with tax equity investors, most commonly amongst the largest US Banks. This enables developers to monetize the tax credits and depreciation.

Typically, with tax equity financing, tax credits are allocated to another party in exchange for an equity investment. Cash is received upfront to help finance the project and in turn the developer assigns the rights to claim the credit as well as the depreciation benefits to the equity investor. These transactions are highly negotiated, complicated, expensive and time-consuming to structure and close. Establishing the partnerships require extensive and costly accounting, legal and consulting services which have posed a considerable barrier to entry for smaller developers and investors alike. As a result, most tax equity investors historically have been larger bank and insurance companies for whom the yield on the transaction has an attractive return compared to making loans. Further complications include developers do not own the assets outright at the start of the project and it can be expensive and difficult to buy out investors, it is not conducive to financing small individual projects due to the cost to structure a transaction and lastly, the investor demand can fluctuate with market conditions.

Recent proposed legislation, Basel III Endgame, could create additional challenges of the traditional tax equity market. Under the proposed rule the capital requirements for tax equity

investments could quadruple. This increase in capital charge would render traditional tax equity prohibitively costly for banks subject to these requirements (banks in excess of $100 billion of assets).

Post IRA: Transferability

Transferability of tax credits on the other hand, has created a new opportunity for developers to monetize their credits through a one-time sale in exchange for cash. Eligible taxpayers can choose to sell all or a portion of the credits to an unrelated eligible taxpayer. This is a less costly, more commoditized and less negotiated alternative to the typical tax equity structure. Furthermore, the cash generated from a sale of tax credits is not included in the seller's taxable income providing added benefit to the seller.

Gaia Risk Management believes that this legislation has the power to transform the redeployment of capital and development of renewable energy organizations. Developers are no longer beholden to cumbersome, complicated and costly equity partnerships to finance projects. This change in transferability provides an array of potential benefits. First and foremost, it dramatically reduces costs associated with forming tax partnerships. This in turn opens up the pool of potential investors, as transaction fees as well as the learning curve associated with tax equity resulted in a limited number of entrants into the tax credit space. Secondly, this should help to broaden the pool of projects as it increases access to financing for smaller projects which would have been priced out of a tax equity transaction. Lastly, this helps with the acceleration of the US green economy and domestic clean energy initiatives in propelling the rapid redeployment of capital within this space.

Gaia Risk Management is committed to driving down the frictional costs of transferability to maximize the value of the tax credit for the seller and buyer, alike.

Tax Credit Transfer Mechanism

What are eligible Tax Credits?

Eligible Tax Credits under the IRA of 2022, per the IRS, include the following:

- Section 48 clean electricity ITC
- Section 48E clean electricity investment credit
- Section 45 renewable clean electricity PTC
- Section 45Y clean electricity production credit
- Section 45U zero-emission nuclear power production credit
- Section 45X advanced manufacturing production credit
- Section 45V clean hydrogen production tax credit
- Section 45Z clean fuel production credit
- Section 45Q credit for carbon oxide capture and sequestration
- Section 30C alternative fuel vehicle refueling property credit
- Section 48C qualifying advanced energy project credit

How does Transferability Work?

The regulations passed around transferability allow for a one-time sale between a buyer and seller. Sellers will have to pre-register the tax credit through an electronic portal with Internal Revenue Service, estimated to be operational by the end of 2023. Once the pre-filing process is complete and a registration number is received, the seller can transfer the eligible tax credit in exchange for cash. The transferee will need to complete a transfer election statement with the

transferor prior to filing a tax return. Per the Internal Revenue Service, "the form and substance of the transfer election statements generally includes the following: name, address and taxpayer identification number for both transferor and transferee, a description of the type and amount of the eligible tax credit transferred and the registration number related to the eligible credit property. The transfer election statement should be also include certain statements and/or representations from the transferor and transferee as described in the guidance." The eligible taxpayer must then elect to transfer any portion of an eligible credit on its original tax return for the year in which the credit is determined to be due, this election is non-revokable.

In terms of when credits can be bought or sold, they can be sold after the close of a tax year but before a buyer files a tax return. Transferees can incorporate purchased eligible tax credits or credits they intend to purchase when calculating estimated tax payments. Furthermore, a tax credit buyer can carry forward the credit for 22 years and back for 3 years. Tax credits can be used to offset up to 75% of taxable income. No taxable income is generated for the seller in the transaction, and no deduction is generated for the buyer. Unlike tax equity structures, it should be noted that the depreciation on an eligible project does not transfer with the tax credit, and the transferee cannot claim the tax depreciation benefit associated with the project.

For transferred eligible credits under sections 48, 48E or 48C or transferred carbon sequestration tax credits under section 45Q, the transferee bears the financial responsibility for a recapture event. The transferor is required to notify the transferee if a recapture event occurs. Due to the nature of this recapture risk and the government mandated qualifications for eligible tax credits, there is a necessary level of diligence one must do on a potential tax credit transfer.

How can Gaia Risk Management Help?

Gaia Risk Management looks to work with buyers and sellers to streamline the due diligence process, aid in securing an insurance wrapper (if desired by buyers) and facilitate a smooth and cost-efficient transaction between parties. Gaia believes the spirit of this legislation is to develop a fairly frictionless transaction for the transfer of ITCs and PTCs in order to further the nation's goal to reach net zero by 2050. We believe that in serving as a one-stop solutions provider for buyers and sellers that Gaia can negotiate economies of scale with third party providers to drive down transaction costs and improve transaction timing for buyers and sellers, while helping to move the nation forward in its clean energy pursuits.

Gaia Risk Management works with potential tax credit producers and purchasers as well as appropriate legal, consulting, valuation and insurance agents to create transfer solutions for both parties. We will provide investment memos outline potential transactions which outline salient details regarding the tax credit as well as a comprehensive review of all reports and appraisals pertaining to the project.

Appendices

What are Tax Credit Adders?

In addition to extending upon existing tax credit programs, the Inflation Reduction Act aimed to focus on a number of domestic initiatives. Principal amongst them are 1) a renewed focus on domestic manufacturing and job creation as well a fair wage and apprenticeship programs for those jobs, 2) repurposing or reinvigorating areas effected by the production, processing, extraction or transportation of non-clean forms of energy, and 3) increasing access to clean energy and creating environmental justice for all. These adders have the ability to increase the base ITC rate of 30% and PTC rate of 2.75¢/kWh, for projects under 1MW, or 6% and .5¢/kWh, for projects greater than 1MW by the following amounts:

1) **Wage & Apprenticeship Requirements**- up to a base rate of 30% ITC and 2.75¢/kWh if following conditions are met for projects greater than 1MW.

   - Taxpayer needs to pay laborers and mechanics employed in construction, alteration on repair no less than prevailing wage rates, as determined by the Department of Labor

   - Employ apprentices form registered apprenticeship programs for a certain number of hours for any taxpayer, contractor or subcontractor employing four or more individuals on an eligible facility. For facilities beginning construction in 2023, qualified apprentices must perform 12.5% of total labor hours.

   *Projects less than 1 MW are exempt from these requirements. For projects greater than 1MW, the requirements apply to each year the PTC is claimed, and for 5 years after a project is places in service for and ITC.

2) **Domestic Content** (starting in 2023) – ITC 10 percentage points or PTC 10% bonus

   - Must include 100% domestic iron and steel and 40% domestic content for manufactured products (increases after 2024). Note: Final requirements are not yet published but will become available on IRS website at a later date.

3) **Energy Communities** (starting in 2023) – ITC 10 percentage points or PTC 10% bonus

- *Brownfield sites* (as identified in CERCLA)- A property that has/potentially has contamination, a hazardous substance or pollutant that could complicate the reuse of the site.
- *Statistical areas* which have (or at any time after December 31, 1999, had) (i) (a) significant employment (>.17%) related to the extraction, processing, transport, or storage of coal, oil, or natural gas or (b) 25% or greater local tax revenue from the foregoing activities, and (ii) higher unemployment than the national average for the "previous year"
- *Coal closures*- A census tract in which after December 31, 1999, a coal mine has closed, or after December 31, 2009, a coal-fired electric generating unit has been retired, or which is directly adjoining to any census tract.

4) **Environmental justice credit (LMI)** – 10 or 20 ITC percentage points (no PTC adder)

- Only applies to solar & wind projects <5 MW of capacity.
- IRS will start accepting applications in 3Q 2023. IRS saying can't be in service before allocation granted.
- Key concept of "benefiting" low-income communities and residents remains to be defined by IRS.

Government Resources:

https://www.irs.gov/credits-deductions/elective-pay-and-transferability

https://www.irs.gov/credits-deductions/elective-pay-and-transferability-frequently-asked-questions

https://www.irs.gov/inflation-reduction-act-of-2022

https://www.epa.gov/green-power-markets/summary-inflation-reduction-act-provisions-related-renewable-energy

https://www.energy.gov/eere/water/inflation-reduction-act-tax-credit-opportunities-hydropower-and-marine-energy

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