

Renewable Energy Tax Credits: Green Energy Saving Greenbacks

By Joshua D. Smeltzer*

Joshua D. Smeltzer examines renewable energy tax credits.

The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails.

— William Arthur Ward



The world needs energy, and increasingly more of it, but people are becoming concerned that the production of energy be done responsibly. A growing trend involves efforts to create more energy from renewable sources in hopes of both creating the energy we need without damaging the environment in which we live. The new Biden administration is clearly signaling that renewable energy will be a key focus of its plan going forward. For example, the Biden administration has set a goal to deploy 30 gigawatts of offshore wind generation capacity by the year 2030. Therefore, it can be expected that tax advisors will be seeing more questions about renewable energy tax incentives as investment in the sector increases.

A large driver of investment in renewable energy is caused by specific tax credits offered as part of the deal structure. However, tax credits are strictly construed by both the IRS and the courts and must follow specific guidelines. Therefore, if the partnership, associated agreements, and negotiations and dealings among the investors and developers of renewable energy are not done properly the tax benefits might disappear.

The Basics of Renewable Energy Tax Credits

Investment in renewable energy has been a tax incentive for many years now, but the benefits were approaching phase-out until they were renewed as part of the Consolidated Appropriations Act. The new legislation provided both COVID pandemic relief and extended the tax credits associated with renewable energy such as solar, wind, biomass, geothermal, and others. The primary tax credits involved for renewable energy are the Production Tax Credit (PTC) and Investment Tax Credit (ITC). However, the new law also created a new stand-alone tax credit

JOSHUA D. SMELTZER is a Counsel at Gray Reed & McGraw, P.C. and a former Department of Justice, Tax Division Honors Attorney.

for offshore wind projects. These changes are all designed to encourage more investment in renewable energy going forward but, as with any tax benefit, taxpayers and their tax advisors must be careful to follow the rules carefully.

Production Tax Credit

The PTC is governed by Section 45 of the Internal Revenue Code (IRC). The PTC under Code Sec. 45 was also extended for one year. Primarily used for wind projects, it also applies to production of electricity from other reviewable sources that begins construction in either 2020 or 2021 (*i.e.*, biomass, geothermal, landfill gas, trash facilities, qualified hydropower and marine and hydrokinetic renewable energy facilities). If construction begins after 2021 then there is no eligibility for any PTC.

The new Biden administration is clearly signaling that renewable energy will be a key focus of its plan going forward.

Recent IRS guidance has provided inflation-adjusted amounts for producers of electricity from renewable sources. However, there are different percentages allowed depending on the renewable source used. The PTC is 2.5 cents per kilowatt hour (kWh) for 2021 for electricity produced from wind, closed-loop biomass, and geothermal energy. The PTC is 1.3 cents per kWh for 2021 for electricity produced from open-loop biomass, landfill gas, trash, qualified hydropower, and marine and hydrokinetic sources. The PTC is \$7.384 per ton for 2021 for refined coal, which is a modest increase from previous amounts. In all cases the electricity must be produced and sold to an unrelated third party.

Effective for renewable electricity production facilities placed in service after 2008, the construction of which begins before January 1, 2022, taxpayers otherwise entitled to the PTC (determined on a cents per kWh basis) may elect the ITC, under Code Sec. 48, in lieu of the PTC. The election is irrevocable. The energy percentage is 30% for such property making the election. Under the election, any qualified property that is part of a qualified ITC facility is treated as energy property. If the taxpayer makes the election, no production credit for any year is allowed for any qualified ITC facility.

To make the irrevocable election to treat a qualified facility as a qualified investment credit facility, the taxpayer

must make a separate claim for the ITC on each qualified property that is an integral part of the facility using a completed Form 3468 filed with the taxpayer's timely filed (including extensions) income tax return for the year in which the property is placed in service.

Investment Tax Credit

The ITC under Code Sec. 48 was extended by two years. This tax credit is popular for solar energy projects as well as other technologies (*e.g.*, fuel cells, microturbines, small wind energy.) However, it is the solar energy companies that appear to primarily be using the ITC. In general, solar projects beginning construction in years 2020 through 2022 are eligible for a 26% ITC, 22% ITC in year 2023, and 10% after 2023. The ITC is similar for other technologies except that it drops to 0% if construction begins after 2023, or if the project is placed in service after 2025.

The new standalone ITC for offshore wind has different specifications. These are facilities located in the inland navigable or coastal waters of the United States. Offshore wind projects are eligible for a 30% ITC for projects beginning construction before 2026 without any apparent phase-down provisions like contained in the other renewable ITC projects. The extension of the PTC requires construction to begin in 2021, so it can be expected that most wind energy investment will likely move to these new offshore wind ITC guidelines.

The property must be qualified energy property, construction must be done by the taxpayer, must be property that is allowed to be depreciated or amortized, must meet performance and quality standards, and must *NOT* be part of a facility where production is taken into account in computing the credit for electricity produced from renewables or which the taxpayer receives a grant in lieu of the energy credit. This includes solar, geothermal, fuel cell, microturbine, heat and power systems, and qualified small wind energy property that begins construction before 2024. Energy property also includes property that is part of a renewable electricity production facility placed into service after 2008 and beginning construction before January 1, 2022 if the taxpayer makes an irrevocable election to treat facility as energy property and no production credit has been allowed. It is important to note that the IRS indicated that it will *NOT* issue rulings on the application of the beginning construction requirement.¹ Beginning construction is determined by two tests (*i.e.*, physical work test and a 5% safe harbor).² Both methods require that a taxpayer make continuous progress towards completion once construction has begun. If a facility is placed in service by the end of a calendar year, that is no more than four calendar years after the calendar year during which

construction of the energy property began, the energy property will be considered to satisfy the requirements.

Each type of renewable energy (solar, geothermal, *etc.*) has its own unique qualifications for which property qualifies for the credit. Therefore, tax advisors must look at each piece of specific property to ensure that it qualifies for the tax credit. This includes the type of renewable energy involved and when it needs to be placed into service. Also, if multiple properties are involved there are special rules for treating the property as a single project.³

Taxpayers should also be aware that there is sometimes a risk of ITC recapture. This recapture usually occurs in two situations. First, when an unvested portion of the ITC is recaptured due to something that occurs after the project is placed in service. The ITC usually vests 20% each year, after placed in service, and if the taxpayer disposes of the project or the project is otherwise no longer eligible for the ITC the unvested portion might be recaptured. A change of ownership (*e.g.*, lease or sale-leaseback) is unlikely to qualify as disposal, depending on the specific facts involved. The second situation involves an IRS determination that the credit was not allowed in the amounts claimed (*e.g.*, inflated costs or costs misallocated to ITC eligible equipment). This IRS determination might also cause recapture.

The Implementation of Renewable Energy Investments and Tax Credits

Developers and investors use a variety of business structures to invest in renewable energy. However, the primary structures tend to be investment partnerships, sale-leaseback transactions, and inverted lease transactions. Each structure has different benefits and detriments that should be carefully considered.

One of the most popular structures is a partnership flip transaction where a majority of the tax credit benefits are given to the investor until a specific point when the percentages then flip to the developer. This structure mimics a similar structure used by the IRS as a safe harbor for PTC projects involving wind.⁴ However, IRS Chief Counsel Advice⁵ has indicated that this structure is limited to PTC credits and wind. Therefore, although it provides guidance on what appears to be acceptable under the partnership rules, it should not be seen as a “safe harbor” for anything other than PTC partnerships involving wind. If questioned by the IRS, this explanation can help provide support for compliance with the applicable partnership rules but will probably not avoid IRS scrutiny entirely. In this structure there is a capital infusion from the project developer and the tax equity investor, the partnership then constructs the

project, customers make payments for the power services, and then prior to the “flip” the partnership distributes 99% profits/losses, most of the tax credits, and some cash to the tax equity investor and the remaining 1% to the project developer. The “flip” is where the allocations of profit/losses, cash, and any tax credits between the developer and investor change at either a pre-determined date or a target yield or other pre-determined condition. The flip usually occurs after five years to avoid recapture and, after the flip, the developer usually has the option to buy out the tax equity investor. There are several variations, but this is the basic structure and the further away from this structure you get the less you will be able to claim its similarity to the safe harbor provisions of the PTC for wind it is based on. The primary advantages of this structure are that it is easy to close and monetizes most or all of the tax benefits available and allows the developer and investor to part ways relatively easily when the agreed benefit is reached. Its primary disadvantage is that the developer will need to contribute equity and at least a portion of the losses and credits will be allocated to the developer that may not need such losses or credits.

Beyond limitations specifically listed in the Internal Revenue Code, all transactions are subject to the judicial doctrines of substance over form, step-transaction doctrine, and the economic substance doctrine.

Another fairly common structure is a sale-leaseback transaction. In this transaction, a project developer locates a customer and signs an agreement for services, the developer then builds the system and sells the system to a tax equity investor. The developer leases the system from the tax equity investor and the developer incurs all costs of operations. At the end of the project the developer may purchase the project or extend the lease. The tax equity investor can usually claim the tax credits, depreciation, and receive the cash flow as owner of the energy property. The lease term, again, usually exceeds five years in order to avoid recapture under the ITC. Although, if the costs are high enough the lease term might be 10–15 years. The primary advantage of a sale-leaseback transaction is that the investor finances the entire cost of the project through the purchase price. It may have some developer costs (*e.g.*, capital contributions

during construction or lease pre-payments) but generally requires the least developer equity. Also, 100% of the tax benefits are absorbed by the investor instead of a part of the tax benefits being left with a developer that may not need those benefits. The primary disadvantage is that there are stringent agreement rules such as fixed rent schedules, indemnifications, and potential guarantees.

A less common structure is an inverted lease structure. In this structure, a tax equity investor leases the systems from the developer, the tax equity investor then makes an agreement to provide services with a customer, customer pays the tax equity investor for services and investor then pays the developer. This also allows for the investor to take 100% of the ITC. There is sometimes a partnership variation on this inverted lease structure.⁶ Similar issues can be present in the inverted lease variant as both the sale-leaseback and partnership flip structures depending on the details of the transaction. Therefore, unless this structure serves a specific purpose, other more traditional options are probably a better option.

Potential Risks Involving Applicable Tax Rules

Tax benefits are considered a matter of legislative grace and are closely scrutinized by both the IRS and the courts. Therefore, tax advisors must be aware of traditional tax principles, developed by the IRS to combat abuse of the tax credits, and other rules in the IRC.

Passthrough ITC is based on the Fair Market Value (FMV) and that involves having a qualified appraisal and all the rules surrounding a properly done appraisal. Partnerships passing through losses and credits must abide by both the “at risk”⁷ rules and the “passive activity rules”⁸ when applicable. Also, in the lease context, the IRS has specific rules that must be followed under Code Sec. 467.⁹

Beyond limitations specifically listed in the Internal Revenue Code, all transactions are subject to the judicial doctrines of substance over form, step-transaction doctrine, and the economic substance doctrine. The agreements and actions of the parties must document a clear business purpose outside of the tax benefits and show that all parties have a meaningful upside and downside potential outside of any tax benefit. An investor may desire, and a developer may be willing to provide, certain guarantees or indemnifications that could prove problematic if the tax credits are later challenged by the IRS. For example, direct or indirect guarantees of the investor being able to claim the credit, cash equivalents of the credits, guaranteed repayment of capital contributions because the credit can’t be claimed, or guarantees of repayment or indemnification if the credit is challenged by the IRS all might cause problems. Just because Congress is encouraging the use of these benefits, does not prevent the IRS or the courts from doing an economic substance analysis and disallowing benefits.¹⁰ Therefore, the terms of the agreement must be evaluated carefully for provisions that could raise questions about the parties having a real stake in the transaction.

ENDNOTES

* Mr. Smeltzer can be reached by email at jsmeltzer@grayreed.com.

¹ See Rev. Proc. 2021-3.

² See IRS Notice 2018-59.

³ See *id.*

⁴ See Rev. Proc. 2007-65.

⁵ CCA 201524024.

⁶ See Rev. Proc. 2014-12.

⁷ See Code Sec. 465.

⁸ See Code Sec. 469.

⁹ See Code Sec. 467.

¹⁰ See *Alt. Carbon Res., LLC, FC*, 939 F3d 1320 (2019) (denying taxpayer argument that the benefits approval by Congress prevented economic substance analysis).

This article is reprinted with the publisher’s permission from Taxes The Tax Magazine®, a monthly journal published by CCH Incorporated. Copying or distribution without the publisher’s permission is prohibited. To subscribe to Taxes The Tax Magazine® or other journals, please call 1-800-344-3734 or visit taxna.wolterskluwer.com. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.