Accounting for Energy Tax Credits

Audit Insights

May 2022

The Wild West of renewables: Accounting for energy tax credits

In its infancy, the renewable energy market was the purview of traditional power suppliers and vertically integrated utilities who had a thorough understanding of energy tax credits and incentives and knew how to account for them. Today's new entrants look a lot different: they comprise investors in new renewable technology – such as small scale nuclear, hydrogen and battery storage – and companies across industries working to decarbonize their supply chains and advance consumer- and investor-focused ESG initiatives. These new, non-traditional entrants should prioritize gaining a fundamental understanding of the diverse ways to account for these projects to maximize the value of their investments and solidify their position in this once-siloed space.

Examining the accounting and tax landscape for new entrants

Companies typically accumulate energy tax credits in one of two ways: through direct ownership of a qualifying energy property or, in the case of tax equity investors, allocation of credits through investment in a partnership structure.[1] The former includes traditional producers and sellers of energy, while the latter includes companies seeking an alternative means to control their tax costs and support their social responsibility initiatives. Many companies in the latter category are already investing in renewables to advance their ESG priorities, but they may not fully understand the financial reporting implications.

These new entrants are most likely to encounter investment tax credits and production tax credits, each of which has specific accounting implications:

— Investment Tax Credits (ITCs): Tax incentives accrued by entities based on a percentage of the investment in eligible energy-related properties. To account for ITCs, entities can choose to employ the flow-through method – immediately recognizing the ITC income tax benefit when it arises – or the deferral method – initially deferring the ITC benefit and instead recognizing it over the productive life of the underlying asset.

— Production Tax Credits (PTCs): Tax incentives accrued by entities based on the amount of energy produced and sold using eligible processes. From an accounting perspective, entities generally recognize PTCs in the year they arise and are earned.

ITCs and PTCs incentivize a number of renewable technologies, including solar, wind, biomass and hydropower. Many states also offer similar incentives for investment in renewable energy.

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[1] KPMG in the U.S., *Diverse accounting for energy tax credits*, February 2022, https://frv.kpmg.us/reference-library/2022/diverse-accounting-for-energy-tax-credits.html.

Embedding ESG into accounting and tax strategy

As ESG drives more strategic decision-making – for both energy producers and those investing in new sources of renewable energy – understanding the implications of different tax credits on financial reporting becomes even more important. Taxes are both a measure and driver of sustainability – and tension sometimes exists between the two. For instance, a company's tax rate may be lower than that of its peers for several reasons, including its decision to heavily invest in ESG initiatives, such as renewable energy projects. However, ESG rating agencies may look at that company's effective tax rate, see that it is lower than average and choose to reduce its Tax ESG rating. Similarly, public perceptions are often shaped by looking at a company's effective tax rate without inquiring *why* it may be lower.

For these reasons, it is essential that companies choosing to take advantage of energy tax credits make the concerted effort to publicly tell their ESG story. Boards and leadership teams play a critical role in embedding ESG into every department and function. A lack of coordination here may compound both audit and tax risks, as well as damage a company's public image.[2]

Incentivizing innovation: New tax credits could spur additional growth

In 2009, when the American Recovery and Reinvestment Act (ARRA) passed, it marked the first time that the U.S. government incentivized the production of renewable energy through a combination of tax credits, loan guarantees and research grants. The result: tremendous growth in both solar and wind energy. It also paved the way for innovations that have lowered the price for electric vehicle batteries and improved fuel efficiency at scale.[3]

Even with the Build Back Better Act (BBBA) stalled in the U.S. Senate, some of its central provisions, including those that incentivize the production of and investment in renewable energy, may resurface independently. New entrants should be prepared to respond accordingly. Three features of the BBBA provisions in particular – the introduction of nonrefundable bonus energy credits, refundable energy credits and additional eligible technologies – have the potential to spur significant growth in the renewable energy sector.

- Nonrefundable Bonus Energy Credits: These would extend and modify the PTCs and the ITCs for green energy projects, making certain projects placed in service after 2021 newly eligible.

- Refundable Energy Credits: These introduce a direct pay mechanism, which would allow taxpayers to elect to receive a cash payment in lieu of claiming certain energy tax credits. The direct pay amount would be 100 percent of the credit for projects that start construction before 2024 – a game changer for financing renewable projects which frequently rely on tax equity.

- Additional Eligible Technologies: The BBBA would add new refundable credits for clean hydrogen, energy storage, sustainable aviation fuel and zero-emissions nuclear. In essence, this expansion of eligible technologies would modernize the tax code's definition of renewable energy to include projects outside of wind and solar.

The nonrefundable bonus energy credits would generally follow the same methodologies that exist today, making it easier for new entrants to account for them. However, as there is no U.S. GAAP specific to accounting for refundable energy credits, companies would likely account for them as they would a government grant.[4] It is important to note that while the direct pay mechanism contemplated in the BBBA could take the pressure off of the need for tax equity,

[2] KPMG in the U.S., *The Wild West of Renewables: What New Entrants to the Market Should Know*, October 2021, https://info.kpmg.us/news-perspectives/advancing-the-profession/the-wild-west-of-renewables-what-new-entrants-to-the-market-should-know.html.
[3] The White House Office of the Press Secretary, *FACT SHEET: The Recovery Act Made The Largest Single Investment In Clean Energy In History, Driving The Deployment Of Clean Energy, Promoting Energy Efficiency, And Supporting Manufacturing*, February 2016. https://obamawhitehouse.archives.gov/the-press-office/2016/02/25/fact-sheet-recovery-act-made-largest-single-investment-clean-energy.
[4] KPMG in the U.S., *Diverse accounting for energy tax credits.*

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some sponsors, operators and developers of renewable technology may still prefer tax equity over direct pay to protect their bottom line.

Introducing new bonus and refundable energy credits would invite non-traditional entrants to claim a piece of the renewables pie. And expanding the incentives to additional technologies would lead to accelerated development and growth across the energy sector. The implications of these provisions passing Congress means that companies will need to consider what processes and controls they will need to implement and how they will track and report on them.

Marrying the tax and accounting function

Navigating the Wild West of Renewables requires finance leaders to work together to instill confidence with investors and the capital markets. These investments are often complex, raising accounting issues that require significant experience and oversight. Due to the current landscape, investing in and reporting on the investment in renewable energy has implications that last far beyond the current fiscal year.

The board and management should set the tone from the top, providing the structured support for finance leaders to coordinate to mitigate risk and enhance efficiency. Regardless of how the current provisions outlined in the BBBA come to fruition, increasing pressure from investors, consumers, standard-setters and employees will drive more companies to take part in the decarbonization of the U.S. economy.

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