The Wild West of Renewables

Audit Insights

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Three things to know before transferring energy tax credits

The Inflation Reduction Act (IRA) is rife with opportunities to earn tax credits for renewable energy projects. But generating, maximizing and ultimately selling those credits is no walk in the park. With transferability of select investment tax credits (ITCs) and production tax credits (PTCs) now on the table as well, it is paramount that new entrants and industry incumbents alike prioritize high-quality tax and accounting due diligence every step of the way.

Here are three things to consider:

1. **Generating credits.** With extensions, modifications and new credits up for grabs, the market for generating tax incentives is expanding.

Prior to the passage of the IRA in August 2022, energy ITCs and PTCs were available, but they were limited to more traditional forms of renewables, such as wind and solar power. Since then, the breadth of projects eligible for energy tax credits has significantly increased, creating new and enhanced opportunities for energy producers and investors to generate tax incentives.

For one, the IRA includes extensions and modifications for a host of existing credits. These include credits related to wind, solar and geothermal energy; carbon oxide sequestration; the manufacture of energy properties, including electric vehicle components, fuel cells and electric grids; energy-efficient commercial buildings; and charging stations.[1]

In addition to enhancing existing tax credits, the IRA introduced several new ones, the majority of which are designed to bolster cutting-edge renewables technology. These new credits include those related to zero-emissions nuclear power, clean hydrogen, commercial clean vehicles, solar and wind components, batteries and critical minerals, technology-neutral clean electricity, and clean fuel.[2]

With the expanded scope of new and enhanced incentives, the credit supply has and will continue to grow significantly.

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[1] KPMG LLP, *IRA Update: Guidance on Direct Pay and Transferable Tax Credits*, featuring Hannah Hawkins, Katherine Breaks and Julie M. Marion, webcast recorded on July 18, 2023, https://tax.kpmg.us/events/webcasts/2023/direct-pay-and-transferable-energy-tax-credits.html.
[2] KPMG LLP, *Guidance on Direct Pay*.

2. **Maximizing credits.** Getting smart about the IRA's increase and bonus rate provisions is key to maximizing energy tax credits.

Solely producing or investing in an eligible form of renewable energy may be enough to generate an energy tax credit, but increasing that credit rate or becoming eligible for a bonus rate requires careful planning and attention to detail. Let's look at a hypothetical example.

A company is an investor in an energy storage project. Under the IRA, energy storage is eligible for an ITC. However, the ITC's exact rate is dependent on several key conditions. By meeting some or all of these conditions, the company can boost that credit rate.

- **Prevailing wage and apprenticeship:** Ensuring that laborers and mechanics who support the project are paid prevailing wages and that qualified apprentices perform a specified portion of labor increases the credit rate fivefold. A 6% ITC becomes a 30% ITC.
- **Domestic content:** If the construction of the energy storage project utilizes steel, iron or other products sourced or manufactured in the United States, the investor may be able to earn a domestic content credit enhancement, or "adder." In our example, the 30% ITC could become 40%.
- **Energy communities:** Locating the energy storage project in a coal mining town, on a brownfield site or on another eligible tract of land can boost the credit rate another ten percentage points, all the way to 50% if the first two conditions have also been met.

A 50% ITC, relative to 6%, can make a world of difference. In theory, it could be the difference between greenlighting that energy storage project and passing on it. These rate provisions may look straightforward on paper, but there are a number of intricacies that arise when putting them into practice. It is critical that taxpayers not assume a project will automatically meet the criteria for an increase or bonus rate.

As a starting point, generators, purchasers, investors and their advisors must be ready to dig into the details. For example, domestic content requirements can be quite granular, particularly when zooming in on the component and subcomponent level of manufactured products. Prevailing wage and apprenticeship requirements entail reading the fine print as well; they are applicable not only during the construction of the project, but possibly also for several years after it begins operations.[3] And finally, the map of energy communities is not cut and dry. Projects may span multiple tracts of land, and the energy community definition may change from year to year.

These considerations only scratch the surface, but they demonstrate how important it is for credit generators to carefully document all elements of a credit and for credit purchasers to conduct proper due diligence before claiming a specific credit amount on a tax return. The taxpayers claiming the credit on their return are on the hook for much of the related risk. They would be wise to obtain documentation from the generator of the credit, and many are requiring indemnifications and insurance to mitigate risk.

3. **Transferring credits**. For companies looking to sell or buy transferable energy tax credits, properly accounting for and documenting all transaction information is critical.

Under the IRA, eligible energy producers may choose to monetize their transferable tax credits by selling the credit to a third party. Per proposed regulation from the IRS, each transferable tax credit must be treated individually, transferred only one time and solely for cash.[4]

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[3] KPMG LLP, *Handbook: Tax Credits*, May 2023, https://frv.kpmg.us/content/dam/frv/en/pdfs/2023/tax-credits-handbook.pdf.
[4] KPMG LLP, *Guidance on Direct Pay*.

While the market for transferable tax credits is still taking shape, purchasers are expecting to be able to buy credits at a discounted rate. This discount may be based on the type of credit, the quality of the credit and the indemnification and creditworthiness of the seller. With this discount in mind, purchasers and sellers of energy tax credits have their work cut out for them to ensure that proper documentation is presented during the transaction and that the transaction is appropriately accounted for in the financial statements.

One consideration is the aforementioned components of each transferable credit. While each credit can be transferred, the bonus credits and credit adders cannot be separated. In other words, the purchaser must be prepared to take on the risk profile for the base credit, bonus credit and any applicable adders.[5] Another consideration is financial reporting. Auditors will be looking for supporting documentation to validate the financial reporting of the credit and related discount.[6]

Regardless of whether an entity is the purchaser or seller in a transaction, properly assessing the accounting and tax risks is key to making the most of the IRA's transferability provisions.

Taming the Wild West?

As the true impact of the IRA takes shape, it's tempting to say that the Wild West of renewables is beginning to look a little less "wild." After all, a plethora of renewable energy projects are now in scope, and new IRS tax guidance as well as new accounting guidance and principles are rolling out. But this does not mean that new entrants and industry incumbents can ease up. On the contrary, even as market participants gain clarity in tax legislation, countless new questions and challenges are coming to the forefront. Cost of financing, for example, has significantly increased in the past year, and many renewable energy projects have stalled indefinitely as a result. Moreover, the effects of global supply chain disruption and inflationary pressures continue to ripple across the industry.[7] Tax incentives hold undeniable potential, but are they enough to tame the Wild West?

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[5] KPMG LLP, *Direct Pay and Transferable Credit Proposed Regulations: KPMG Analysis and Observations*, June 27, 2023, https://assets.kpmg.com/content/dam/kpmg/us/pdf/2023/06/kpmg-report-direct-pay-transferable-credit-proposed-regs.pdf.
[6] KPMG LLP, *Handbook: Tax Credits*.
[7] KPMG LLP, "The Wild West of Renewables," April 25, 2023, https://info.kpmg.us/news-perspectives/advancing-the-profession/wild-west-of-renewables-2023.html.

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