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Federal Credit Sales May Create Unexpected State Tax Headaches

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Taxpayers generating, selling, and using federal renewable energy credits should beware of potential state tax liability if a state doesn't conform to federal income exclusions, warn KPMG's Daniel De Jong and Jasmine Desai.

Congress and President Biden enacted the Inflation Reduction Act, Pub. L. No. 117-169 (IRA), on August 16, 2022, in part to incentivize investments in renewable or "green" energy. These incentives provided for the direct sale of certain federal income tax credits to third parties.

The market for these credits has grown quickly, with 2024 first-half transactions totaling in the range of $9 billion to $11 billion, according to Crux Climate Inc., which has produced a mid-year report suggesting the volume will continue to accelerate, reaching $20 billion to $25 billion by the end of the year.

While sales of these environmentally friendly energy credits are excluded from federal taxable income thanks to the IRA, some states may not conform to those exclusions, potentially creating surprising state income tax liabilities for taxpayers investing in this new and growing market. To best understand the state treatment of these transactions, let's first review how the credits are designed and how the federal government treats them.

Background on the IRA

The IRA extended, expanded, and/or established a slate of federal income tax credits — for example, the §48E Clean Electricity Investment Credit; the §45Q Carbon Oxide Sequestration Credit; §45U Zero-Emission Nuclear Power Production Credit; the §45V Credit for Production of Clean Hydrogen; the §45Y Clean Electricity Production Credit; and the §45X Advanced Manufacturing Production Credit.

The IRA also created new Internal Revenue Code (IRC or Code) sections to allow eligible taxpayers to monetize applicable green energy credits. Under new §6417, eligible entities may elect to receive direct payments from the federal government for certain credits they generate. This election is generally limited to governmental entities and organizations generally exempt from federal income tax under §501(a). However, under §6417(d), taxable entities may make the direct payment election for several eligible credits — including the credits under §45Q, §45V, and §45X.

Under new §6418, eligible entities may elect to sell to unrelated taxpayers all or a portion of certain eligible credits that they generate — for example, the credits under §45X, §45Y, §48E, §45Q, §45U, and §45V.

Below, we'll look at the possible tax consequences related to the sale of these federal credits if a state does not conform to the federal provisions of the IRA.

Federal Treatment of the Sale of State Income Tax Credits

Historically, taxpayers have generally been prohibited from selling or transferring federal income tax credits directly to a third party, but some states have allowed the sale of certain state income tax credits. The IRS has ruled that when a taxpayer generates and sells a state income tax credit, the transaction is treated as the sale of an intangible asset in which the seller has zero basis. The associated gain is included in the seller's federal gross income under §1001 and is treated as gain from the sale of a capital asset. The purchaser of the credit does not recognize income when it purchases the credit, even if the purchaser pays less than the credit's face value. However, when the purchaser subsequently applies the credit to satisfy its state tax liability, the purchaser recognizes gain for federal purposes equal to the difference between its basis in the credit (the price paid for the credit) and the amount of the state income tax liability offset by the credit, as reflected in CCA 201147024 wherein the Office of Chief Counsel addressed the sale and use of a Massachusetts state tax credit in 2011.

Under §6418, the gain recognized on the sale of IRA credits is excluded from the gross income of the taxpayer selling the credit (the "transferor taxpayer"). Also, while the taxpayer that purchases the credit (the "transferee taxpayer") may not deduct the amount paid for such credit, it does not recognize income when the credit is applied to offset its federal income tax liability.

States May or May Not Conform to the Federal Treatment of IRA Credits

For purposes of computing the state corporate income tax base, states generally conform to the IRC on either a "rolling" or a "static" basis. A rolling conformity state generally adopts the provisions of the Code as they are enacted by the federal government. In other words, a rolling conformity state automatically conforms to the current version of the Code unless otherwise provided by state law. A static or "fixed date" conformity state generally conforms to Code provisions enacted as of a date specified in state law. Through these conformity statutes, states that conform to the Code after the enactment of the IRA generally conform to the tax provisions of the IRA unless a state law to the contrary has been adopted. Conversely, if a state conforms to a pre-IRA version of the Code, it may not conform to the tax provisions related to the sale and use of IRA credits.

California

California, for example, does not conform to a version of the Code that includes the tax provisions of the IRA. Instead, it conforms to the Code as in effect on January 1, 2015 (with limited exceptions not relevant to IRA credits). This could create unpleasant surprises for taxpayers selling IRA credits. Because California does not conform to the tax provisions of the IRA, California will not pick up the §6418 exclusion from federal gross income for sales of IRA credits. Instead, the transferor taxpayer likely must include the proceeds from the sale of the IRA credit in gross income as the sale triggers a recognition event under §1001, in the same manner as the sale of state income tax credits. This tax base inclusion then raises a question of whether the income is included in the sales factor and, if included, how to appropriately source the gain. It is possible that the proceeds from the sale of the IRA credits would be excluded from the sales factor under California's substantial and occasional sale rule. On the other hand, if the gain is not excluded, California may treat it as income from the sale of an intangible and accordingly apply its sales factor sourcing rules.

The absence of conformity to §6418 means California does not conform with the corresponding federal regulation that excludes from gross income the use of an IRA credit to offset a transferee taxpayer's federal tax liability when purchasing a credit for less than face value. Thus, when applying the credit to pay its tax liability, the transferee taxpayer likely must recognize a gain equal to the difference between its basis in the credit (price paid for the credit) and the amount of federal income tax liability offset by the credit. This again raises interesting issues regarding the associated sales factor implications, including whether the net gain or gross receipts generated using the federal credit should be included in the sales factor and how those amounts should be sourced.

An increased California tax liability may be compounded by state actions such as the suspension of net operating losses and credits.

In February of this year, 2024 California Senate Bill 1191 was introduced, calling for California to specifically conform to the IRA tax provisions that exclude the sale and use of applicable credits from gross income for state income tax purposes. But that legislation died in committee, leaving taxpayers with the potential for significant California tax liabilities if they sell or use these federal credits.

Other States

Only a handful of states may tax the sale and use of IRA credits based on their lagging conformity to the Code. Texas conforms to the Code as in effect on January 1, 2007, and New Hampshire's fixed conformity date is January 1, 2018. Thus, it would generally appear that because neither Texas nor New Hampshire conforms to the IRA provisions of the Code, these states do not conform to the exclusion from gross income permitted under §6418. Instead, it appears taxpayers must include the sale or use of the eligible credits in their state tax base.

As of this article, neither Texas nor New Hampshire has introduced legislation that would update the state's conformity to the IRC. Also, neither state has legislation in process that would specifically exclude the sales or use of these credits from the state tax base.

Conclusion

To protect themselves from unwelcome surprises, taxpayers generating, selling, and using credits for which the Inflation Reduction Act provides a federal exclusion from taxable income should proactively evaluate the potential for these and other states to include IRA credit

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transactions in its tax base as well as the related effects on the applicable sales factors.

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