Buying transferrable tax credits: Is it right for my company?

Opportunity

The Inflation Reduction Act of 2022 (IRA) extended and introduced several federal income tax credits related to energy transition and carbon reduction and modified a number of the rules applicable to those credits. One of the biggest changes was that **most of the credits are now transferrable to a third party, including to taxpayers who are not themselves engaging in activities that generate tax credits.** This presents an opportunity for companies with federal income tax liability to purchase federal tax credits at a discount to permanently lower the applicable year's tax burden.

Overview

A new and active marketplace is now accessible. Historically, a taxpayer needed to be a direct or indirect owner of an energy project to benefit from the tax credits associated with that project. The IRA changed this and has facilitated a robust and growing market for transferring federal income tax credits.

Now, any taxpayer who is unrelated to the seller, including those **without** any direct or indirect ownership interest in the property or activity giving rise to the credit, may purchase eligible credits at a discount. A conservative estimate suggests that upwards of $30 billion of tax credits will be available each year, and many estimates project much larger amounts.

How it works

Transfer rules.

The proposed regulations from the Department of Treasury and the Internal Revenue Service (IRS), issued in June 2023 under IRC Section 6418, state that, if a project is registered with the IRS and a valid transfer election is made by an eligible taxpayer (Seller) in any taxable year, the specified transferee taxpayer (Buyer) – not the eligible taxpayer – is treated as the taxpayer for the purposes of the IRC with respect to the specified credit portion.

Tax-treatment of purchase price.

- The cash received by the Seller for the sale of the tax credit is not includable in the gross income of the Seller.
- The money that the Buyer pays for the tax credits is not deductible by the Buyer for income tax purposes. However, the difference between the price paid (currently $0.92-$0.93 per $1.00 of Investment Tax Credits) and the amount of credits purchased is not included in the gross income of the Buyer (i.e., it is a pure benefit).

Timing of payment v. timing of benefits.

The Buyer must be paid solely in cash. The payment must be made within a specific time frame that starts on the first day of the Seller's taxable year when a specified credit portion is determined and ends on the due date for completing a transfer election statement.

The payment for the purchase can often be deferred until after the end of a quarter or possibly the end of the year. However, if there is an unconditional obligation to transfer the credits and an unconditional obligation to pay for the credits, these credits can be taken into account to lower quarterly estimated taxes. This results in cash equal to the full amount of the credits/offset taxes appearing on the balance sheet at the end of the quarter. This does not count towards the Buyer's gross income, so it is a pure benefit.

Risks.

Buyers bear risk of adjustments, denials, or recapture of the credits by the IRS or as a result of shutdown of the project, but a robust insurance market exists to help mitigate this risk and counterparty risk associated with Seller indemnities.

Transaction costs.

Sellers often bear the cost of the insurance premiums and both Buyer and Seller legal and broker fees. Therefore, the price paid by Buyer represents the actual cost to them.

Example

Eligible credit value: $100 million
Market discount: $0.92 Per $1.00 of credit
Net purchase price: $92 million
SAVINGS: $8 MILLION (1.26% tax rate benefit*)

*NOTE – CREDIT CAN ONLY OFFSET UP TO 75% OF TAXABLE INCOME

Ideal Buyer

- Corporate taxpayers in any industry with significant federal tax liability
- Minimum tax credit capacity of $20-$30 million per year (to be economical, considering transaction costs)
- Calendar year-end taxpayer (fiscal year-end taxpayers can also benefit from credit purchases but ideally would purchase from Sellers with the same fiscal year-end)

How DLA Piper can help

We help companies pursue strategies to either sell or purchase tax credits and are well positioned to facilitate introductions between appropriate taxpayers. When we represent a Buyer, our team is experienced in identifying the relevant issues that a potential Buyer of credits needs to assess. Seeking knowledgeable counsel is encouraged considering the Buyer bears the burden of the required documentation in addition to the risk of loss/recapture of credits. We can help Buyers of credits:

- Evaluate qualification for credits and the various bonus credits,
- Assess the relative risks associated with different types of credits,
- Negotiate access to relevant documentation and help build an audit file,
- Structure indemnities and insurance coverage,
- Evaluate the impact of buying credits under Pillar 2, base erosion and anti-abuse (BEAT) tax, and other US and non-US tax rules,
- Structure purchase agreements that allow for some flexibility in bringing in third-party purchasers, if necessary