How to Register and Audit Clean Energy Credits

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The credit transfer provision of section 6418 has given developers of clean energy products and producers of clean energy who don't qualify for direct pay under section 6417 an alternative to tax equity transactions. The goal of allowing transfers is to encourage clean energy projects, including smaller ones, without encumbering them too much with high transaction costs and complexity.

But transfers are a novelty, and Treasury and the IRS's self-imposed spring deadline to issue guidance under sections 6417 and 6418 is rapidly approaching. Several looming questions remain about how the new transfer system will work as it grows, one of the biggest being how the IRS will verify credits and audit the taxpayers who buy them.

New Developments in Direct Pay

The focus of this article is transferability, but there are a few points about direct pay and applicable entities that were discussed at the American Bar Association Section of Taxation meeting on May 5 that need to be mentioned. Sarah Haradon of the Treasury Office of Tax Policy said that future guidance will address whether an applicable entity may make a credit purchase and subsequent direct-pay election, but declined to say what the answer would be. It should be no.

Congress thought about extending direct pay to everyone in the Build Back Better Act, which was essentially a rough draft of the Inflation Reduction Act (IRA, P.L. 117-169), but the enacted version of the IRA dramatically narrowed the population of potential recipients. Treasury and the IRS would have a hard time extending it beyond applicable entities because that would position those entities to become middlemen. The statute does not suggest that Congress intended to do that. But there is one instance in which tax-exempt organizations are likely to be able to buy credits: when they will use them against unrelated business taxable income. That is a reasonable interpretation of the statute.

The IRS is working on an electronic prefiling system for the direct-pay election for applicable entities, according to Amber MacKenzie of the Treasury Office of Tax Policy, who also spoke at the ABA meeting. A registration system for transfers is one of the options for administering the novel transfer regime. It's a good idea for both taxpayers and the IRS, but the details of the system will make a big difference in whether it will be as good in execution as it is in theory.

Registering Transfers

The problem that faces both buyers and the IRS is that after a transfer has taken place, the party possessing much of the information needed to show compliance with the credit rules is not necessarily still in the picture. Developers have a reasonably high degree of self-interest in ensuring that the IRS has what it needs to ensure that the transfer program works fluidly, because if it doesn't, some of the market might dry up. But there is no statutory requirement that they cooperate. Section 6418(a) provides that once an eligible taxpayer has elected to transfer all or any part of an eligible credit, the transferee taxpayer is treated as the taxpayer for purposes of title 26 regarding the credit or portion of the credit that they purchased. That complicates the question of how the IRS will handle audits.

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Not only do the basic credits eligible for transfer require information that the buyer has access to only if it negotiates for it, but the IRA's new provisions on prevailing wages, apprenticeships, domestic content, and energy communities all require added information that the developer has mostly exclusive access to — or at least is in the best position to provide.

Because the buyer is the taxpayer under section 6418(a), absent guidance that includes the seller in some way, it could be difficult for buyers to comply with audit requests and provide the information needed to substantiate the credits they claim. Some of the necessary information sharing will be secured through contracts and likely backstopped by indemnification agreements that transfer the amount of any adjustment to the seller. But a regulatory mechanism may also be needed to ensure that sellers assist, at least to an extent, in audits. The place to do that is probably through a registration process in which both buyers and sellers participate and agree to participate in any possible future audits.

For developers who wish to sell credits, there is an incentive to help make the new regime a success to preserve the possibility that Congress agrees to similar experiments in the future. Senate Finance Committee member Charles Grassley, R-Iowa, recently spent some time in the Senate Budget Committee grousing about transferability and recounted how similar innovations enacted decades ago in the safe harbor leasing rules didn't work nearly as well as lawmakers had hoped, which led to their early demise.

The Economic Recovery Tax Act of 1981 introduced a safe harbor for leases so that taxpayers who couldn't use the depreciation and investment credits associated with owning qualified property could transfer those benefits to taxpayers who could use them. A year later, in the Tax Equity and Fiscal Responsibility Act of 1982, Congress made an abrupt turn that first reduced and then repealed safe harbor leasing. The Senate Finance Committee explained that "the present safe-harbor rules have enabled some taxpayers to avoid their equitable share of tax," and the Joint Committee on Taxation observed that "Congress believed that the adverse public reaction to such practices and to the institutionalized commerce in tax deductions and credits was too likely to diminish respect for and compliance with the tax laws on the part of the general taxpayer" (JCS-38-82). Congress also had a deficit problem on its hands in 1982 that made the revenue cost of safe harbor leasing a more attractive target for elimination. To avoid a repeat of that scenario and create a functioning transfer market, transferors will need to participate post-transfer. The history of the early renewables credits includes a similar quick change that made a highly attractive tax credit less enticing: The Energy Tax Act of 1978 allowed refundable credits for solar and wind energy property, but those credits were quickly made nonrefundable in the Windfall Profit Tax Act of 1980.

The IRS and Treasury have at least a couple of options to pursue in the coming rules. The New York State Bar Association Tax Section's report suggested that one of them is to audit the eligible taxpayer to determine whether the credits are valid before auditing the transferee. "This is broadly analogous to the rules under Sections 6221 et seq., where the Service generally must first audit and assess a partnership with respect to partnership items, before potentially seeking to recover from the partners," the Tax Section explained. Audits of transferors before transferees would give the IRS the information it needs to substantiate the credit and transferees notice and time to prepare, but transferors might balk at bearing the brunt of the audit process. This option should largely avoid the confidentiality problem that faces the IRS in deciding how to conduct audits of transfers.

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The ABA tax section's comments on Notice 2022-50, 2022-43 IRB 325, suggested requiring both the eligible taxpayer and the transferee to file documentation, prepared by the eligible taxpayer, that attests to the amount and origin of the credit that is transferred. The comment letter asked that the government request information that is ordinarily generated in the course of business, and that any novel information or documentation be kept to a minimum. This type of documentation would fit into a registration program and could also be combined with an approach that audits the transferor first.

As the ABA tax section's letter noted, one of the chief concerns for transferors and transferees regarding a registration system is the potential compliance burden it may entail. While a robust registration system would likely help the IRS administer the program and the net benefits of a well-functioning program would accrue to potential transferors, a complicated registration process could also hinder transfers.

The complexity of the registration system will be a function of how many taxpayers are allowed into the credit market, which will depend on a critical determination the IRS and Treasury are likely to make in the proposed rules, said Matt Donnelly of Gibson, Dunn & Crutcher LLP. "If the passive activity credit rules apply to credit buyers, which would have the effect of excluding an enormous portion of the credit purchasing population, then the system could be simpler," he said. Conversely, if the rules say that the section 469 rules don't apply, a much more fulsome registration system will be needed. The application of the passive activity credit rules would mostly exclude individuals from buying credits.

If Congress didn't want section 469 to be a crimp on the transfer market, it could have been more explicit in section 6418(a), or at least added "only" to the explanation that the transferee taxpayer "shall be treated as the taxpayer for purposes of this title with respect to such credit." Congress should not have put Treasury and the IRS in the position of having to make this decision.

While the substantive guidance will provide the IRS and Treasury's views on questions like the applicability of section 469, there has been a recent indication of how the transfer registration system may take shape. In April the IRS released instructions for filing Form 3800, "General Business Credit," for short tax years that begin in 2023 and end before December 31, 2023. The modifications that the instructions require taxpayers to make to the form offer a rough draft of the registration requirements for transfers. The taxpayer must provide a copy of the written transfer agreement, which must include information about the buyer and seller, a statement "that provides the necessary information and amounts to allow the transferee taxpayer to take into account the transferred credit with respect to the facility or property," the total amount of the credit, the first tax year in which the credit will be taken into account by the transferee, and the cash consideration amount and date paid by the transferee. There also must be a statement from the eligible taxpayer, made under penalty of perjury, that it has fully complied with section 6418 and the eligible credit code section, as well as the applicable prevailing wage, apprenticeship, and domestic content requirements. Those things should be in the transfer agreements already. The IRS will likely want to add more information to the registration system as it builds out the program.

Another issue that will define the registration process for transfers is credit recapture. The IRS and Treasury will have to clarify who the credit could be recaptured from and how, said Carina Federico of Crowell & Moring LLP. The statute isn't clear, but the answer to this question in the coming guidance should be reflected in the registration process and any forms that transferors and transferees file.

Section 6418(g)(1) allows the Treasury secretary to make registration, including pre-registration, a condition of any transfer. That implies that cooperating with the registration process can be used as a prerequisite for any subsequent transfers and gives the IRS and Treasury a little more leverage on registration requirements.

However the registration system is ultimately designed, it also must address the issue of confidentiality. Transferors won't want to share information with transferees beyond what is necessary to effect the transfer. Having to audit someone other than the taxpayer who did the activity that gave rise to the credit puts the IRS in a bit of an awkward position regarding section 6103, which may make auditing the transferor first the more appealing option.

Concerns about fraud will likely prompt the IRS to be active in auditing transfers, especially in the first couple of years. The direction that the proposed regulations take on open questions like recapture will help define the focus of those initial audits, said Federico. She added that the IRS will likely select an aspect of the IRA for a compliance campaign. There is precedent for campaigns on energy credits — one of the first campaigns, announced in 2017, was on the section 48C advanced energy credit.

DOCUMENT ATTRIBUTES

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