LAW360

Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10169 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Investments In Energy Tax Credit Boom Could Draw IRS' Eye

By **Kat Lucero**

Law360 (October 29, 2024, 6:58 PM EDT) -- The 2022 climate law's green energy tax incentives sparked a surge of big-ticket development projects nationwide, and tax practitioners expect that the investments could be subject to intense scrutiny from the IRS amid a crackdown on abusive schemes in other areas.

Over the past two years, the U.S. Treasury Department and Internal Revenue Service have released a flurry of guidance on the 2022 Inflation Reduction Act's complex yet valuable tax provisions for the scores of development projects seeking to claim credits and other incentives for storing and producing less carbon-intensive types of energy, such as solar, wind, clean hydrogen and geothermal energy.

While the government has developed detailed regulations for the new or updated tax provisions to provide businesses certainty and discourage abuse, such large-scale investments carry inherent risks, including potential extra attention from the IRS, according to Daniel Strickland, a partner in Holland & Knight LLP's Washington, D.C., office.

The agency may seek to crack down on and curtail abuse related to new transactions tied to the 2022 law, similar to the way it has policed other arrangements with generous tax perks — notably, the charitable tax deduction for easement donations under Internal Revenue Code Section 170(h) and the employee retention tax credit — Strickland said.

"The expectation is that some version of those playbooks will be utilized in scrutinizing" the clean energy tax credit transactions, Strickland told Law360.

Before the 2022 law, tax equity was the main financing avenue for project owners and sponsors that wanted to claim the existing clean investment and production tax credits for solar and wind energy properties.

Such investors, however, were limited to big banks and other large corporations with large enough tax liabilities to absorb credits worth hundreds of millions of dollars. They also had immense resources to heavily scrub the projects in due diligence before agreeing to any deal, which is why the IRS took more of a hands-off approach in auditing green energy credit transactions, according to Strickland.

However, that stance may change under the 2022 law, which created two new tax credit monetization opportunities and sweetened some base incentives — such as the investment and production tax credits, qualifying advanced energy project tax credit and carbon oxide sequestration credit — with sizable bonus credits. The law also created new credits, including the advanced manufacturing production tax credit under IRC Section 45X to boost the green energy supply chain in the U.S.

In implementing the new provisions, Treasury and the IRS developed comprehensive and detailed regulations because the provisions significantly added to the complexity of renewable energy financing, according to Scott W. Cockerham, a partner at Latham & Watkins LLP.

"The volume of questions these concepts raised necessitates a detailed guidance package," he told Law360.

The same law also gave the IRS additional funding for enforcement, which means clean energy tax credit transactions are also bound to get extra scrutiny, according to tax controversy practitioners.

In enforcement, practitioners expect the IRS to use some of the same techniques it developed in its crackdown on abusive syndicated conservation easement deductions and employee retention tax credits. Similar to the climate law's tax credits, Congress designed Section 170(h) decades ago to encourage conservation by lowering the taxes owed by property owners that donate their open land or old buildings to nonprofits or government agencies. The employee retention credit, meanwhile, was meant to help employers retain their workers amid the economic downturn brought on by the COVID-19 pandemic.

Despite the incentives' altruistic intentions, the IRS has found abusive practices in claiming the benefits and cracked down on transactions, including cases in which taxpayers disputed the agency's findings and even called the enforcement a regulatory overreach. The situation has spurred many suits against the IRS, including those with arguments that it violated administrative law.

The IRS may draw on those experiences in putting together its approach to policing the new green energy tax incentives.

"The tone of what I'm hearing from the IRS is they would like to learn from mistakes in the past with regard to conservation easements and the ERC and to make sure they've got a good plan in place" to deal with the energy tax credits, Carina Federico, a partner at Crowell & Moring LLP, told Law360.

The IRS has already put in place some measures to head off abuse of the green energy incentives. For example, the agency implemented an online preregistration process for clean energy projects that plan to use the new monetization methods — the direct cash payment of tax credits under IRC Section 6417 and the transfer or sale of tax credits under Section 6418 — as an initial barrier for nonqualified companies, according to Federico.

"The purpose of that is really to pick out the very clear instances of fraud, such as a project from a company that is not in the energy industry selling tax credits," she said.

Two years into the law, the IRS has already rooted out an emerging scam that exploits the clean energy tax credits and the new transfer mechanism. In July, the agency said the scam entails return preparers misrepresenting passive activity rules under IRC Section 469 in advising clients to report that they have purchased credits to offset their income tax from their main trade or business activity.

In upcoming audits, the IRS may also identify trending issues or discrepancies in tax return claims for the new bonus credits, which can substantially increase the value of the base tax credit amount if projects meet strict requirements, such as those embedded in the prevailing wage and apprenticeship rules, according to practitioners.

To qualify for those bonus credits, projects must comply with wage determinations under the Davis-Bacon Act and other regulations governed by the U.S. Labor Department and frequently monitor working conditions to minimize penalties. The bonus credit rules also call for a significant amount of recordkeeping, including for payroll, certifications, contractors and other documents that the IRS may request down the road.

"The IRS is going to focus on this to try to understand how folks are documenting," Federico said.

Other issues may also arise related to new tax incentives such the advanced manufacturing production credit, intended for facilities that make, mine or process critical components and materials for clean energy systems and technologies. In final rules this month, Treasury said there is a new regime for the accounting of mining and extracting costs in calculating the tax credit amount, which is a key change from last year's proposed regulations.

The IRS could also examine partnerships, which are commonly used to finance large-scale renewable energy projects, according to practitioners. The advent of tax credit transfers spawned a new hybrid approach — known as the T-flip — which uses the traditional partnership flip's qualities to address transferability's limitations, such as monetizing the property's depreciation benefits.

The T-flip structure allows "flexibility while providing the tax equity investor additional optionality in the event they can't use all of the tax credits and decide to monetize some or all through a transfer," Lee Meyercord, a partner in Holland & Knight's Dallas office, told Law360.

Partnerships are also structured in tax credit syndication deals, in which a partnership entity buys the credits and then partners invest in the partnership according to their tax needs, according to Meyercord.

In the wake of the climate law's additional IRS funding, the agency has intensified its enforcement on partnerships in various industries and transactions. For example, the agency said this year that it would create an office called Energy, Credits and Excise Tax, an offshoot from its existing Passthroughs and Special Industries office. IRS Associate Chief Counsel Holly Porter will oversee the new office, according to an announcement this week.

And over the summer, the agency launched a multiprong regulatory campaign to deter partnerships from inflating the basis of assets without meaningful economic changes to the business. In doing so, the agency also flexed its authority under what practitioners call a powerful anti-abuse tool, the economic substance doctrine in IRC Section 7701.

Partnership basis shifting may come up with clean energy transactions because "there are projects that are selling their interest to a partnership and then claiming that stepped-up basis," Federico said.

Whether or not the stepped-up basis is too much or the right amount "is going to come into play in the audit," she said.

--Editing by Aaron Pelc and Tim Ruel.
