Renewable Energy: Emerging Issues

As society intensifies its focus on environmental impacts, the role of renewable energy has never been more prominent. Environmental, Social and Governance ("ESG") criteria are becoming central to corporate strategies, influencing everything from investment decisions to regulatory frameworks. The landmark Inflation Reduction Act of 2022 ("IRA") was enacted with provisions meant to stimulate private sector investment in the renewable energy space by providing substantial financial incentives to developers, sponsors, investors and companies.[1] Both transforming to clean energy and shoring up our nation's energy infrastructure are essential as the demand for more energy grows due to the proliferation of data centers supporting the cloud, the electrification of buildings and vehicles, and other emerging needs.

The IRA specifically makes robust tax incentives such as the investment tax credit ("ITC") available to stakeholders in the renewable energy sector. However, ITCs come with inherent risks resulting from new requirements imposed by the IRA that must be met in order to maximize the benefit of the incentive. The transfer of these risks to the insurance market has become quite common, leading to increased due diligence procedures required to ensure that underwriters are presented with proper documentation to evaluate and take on the risks. The risks associated with ITCs are multifaceted and include qualification risks, recapture risks and structural risks.[2]

Key Risks and Tax Implications

Qualification Risks

Qualification risks are paramount when dealing with renewable energy incentives such as ITCs. These risks generally relate to the factors which determine the eligible amount of the tax credit that can be claimed. Ensuring that projects meet the host of qualification requirements set forth by legislation and regulatory bodies is essential to secure and maintain benefits.

Recapture Risks

Recapture risks involve the potential for previously qualifying ITCs to be invalidated, even if the ITCs were initially properly claimed. The ITCs are subject to a five-year recapture period, during which the occurrence of certain events can trigger recapture and cause the ITCs to become disqualified.

Structural Risks

Structural risks pertain to the tax structure used to transfer ITCs and whether they will be respected by the IRS in the event they are challenged. While the IRS has blessed certain partnership flip structures used to facilitate the transfer of ITCs, missteps can lead to disallowance of ITCs and other associated tax benefits.[3] Additionally, participants in the renewable energy market have developed new hybrid transferability structures which the IRS has not specifically evaluated in the form of published guidance.

Tax Implications

The IRA allows entities generating ITCs to sell them to third-party purchasers for cash, boosting development activity in the renewable energy sector.[4] Straightforward transferability options are crucial for businesses that cannot fully utilize the tax credits due to insufficient federal tax liability. By selling ITCs, businesses can monetize the tax credits, offering an additional option for project financing to further the purpose of the federal government's initiative.

By recognizing the risks and understanding the tax implications of ITC transfers, stakeholders in the renewable energy sector can be better equipped to navigate the complexities of the relevant incentive programs and help ensure the successful financing of their projects. While tax insurance can be an effective risk management tool in this regard, meticulous planning and due diligence readiness are essential in order to access this market to capitalize on the opportunities and potentially achieve substantial rewards while mitigating risks.

Endnotes

[1] "The Inflation Reduction Act: Towards Sustainable Growth and ESG Integration in the US," Center for Sustainability and Excellence (February 20, 2024). https://cse-net.org/the-inflation-reduction-act-towards-sustainable-growth-and-esg-integration-in-the-us/.

[2] Jordan Tamchin, Joshua Emmett, Matthew Movafaghi, Ben Gerber, and Hamed Khashayar, "Energy Tax Credits: Mitigating Risk With Tax Insurance and Market Trends," Tax Notes Federal (April 15, 2024). https://www.taxnotes.com/insurance-expert/credits/energy-tax-credits-mitigating-risk-tax-insurance-and-market-trends/2024/04/12/7jdpj.

[3] Rev. Proc. 2007-65. https://www.irs.gov/pub/irs-drop/rp-07-65.pdf.

[4] Inflation Reduction Act – Impact and Stories, U.S. Department of the Treasury. https://home.treasury.gov/policy-issues/inflation-reduction-act/impact-and-stories.

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